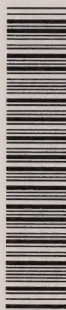


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# Explanatory Notes on Taxation of Non-Resident Trusts and Foreign Investment Entities

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Published by  
The Honourable John Manley, P.C., M.P.  
Deputy Prime Minister and Minister of Finance

October 2003

Canada



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# **Explanatory Notes on Taxation of Non-Resident Trusts and Foreign Investment Entities**

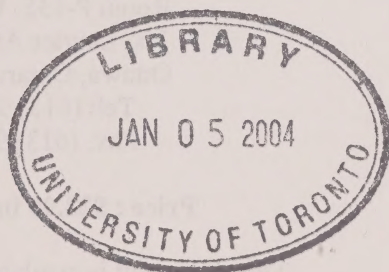
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Department of Finance  
Canada

Ministère des Finances  
Canada

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## PREFACE

These explanatory notes describe proposed amendments to the *Income Tax Act* and a related Act. These explanatory notes describe these amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

The Honourable John Manley, P.C., M.P.  
Deputy Prime Minister and Minister of Finance

These explanatory notes are provided to assist in an understanding of proposed amendments to the *Income Tax Act* and a related Act. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

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## Clause 1

### Income from Business or Property

ITA  
12(1)(k)

Section 12 of the *Income Tax Act* provides for the inclusion of various amounts in computing a taxpayer's income for a taxation year from business or property. Paragraph 12(1)(k) refers to certain dividends required by existing sections 90 to 95 to be so added.

Paragraph 12(1)(k) is amended so that it refers to all amounts required to be added in computing income under amended sections 90 to 95, including new sections 94.1 and 94.2 relating to foreign investment entities. For more information, see the commentary on those sections.

This amendment applies to taxation years that begin after 2002.

## Clause 2

### Loan to Non-resident – Controlled Foreign Affiliate

ITA  
17(15)

Subsection 17(15) of the Act defines expressions that apply for the purposes of section 17, which provides rules under which imputed interest, in connection with debt owing to a taxpayer from a non-resident person, is included in computing the taxpayer's income. The expression “controlled foreign affiliate” is defined to have the same meaning as it does under subsection 95(1) of the Act, except that for the purpose of section 17, a non-resident corporation must be controlled by Canadian residents in order to be treated as a controlled foreign affiliate of a taxpayer resident in Canada.

The definition “controlled foreign affiliate” in subsection 17(15) is amended so that new paragraph 94.1(2)(h) does not apply for the purposes of section 17. Under that paragraph, an election is available under which a foreign affiliate of a taxpayer is generally treated as a controlled foreign affiliate of the taxpayer.

This amendment applies after 2002.

## **Clause 3**

### **Capital Gain from Disposition of Property**

ITA

39(1)(a)(ii.3)

Paragraph 39(1)(a) of the Act describes a taxpayer's capital gain for a taxation year from the disposition of property. This paragraph provides that gains from dispositions of specified properties are to be excluded in determining a capital gain. Under subparagraph 39(1)(a)(ii.2), the specified properties include specified debt obligations, where subsection 142.4(4) or (5) applies to the disposition, and mark-to-market properties where subsection 142.5(1) applies to the disposition. Under subparagraph 39(1)(b)(ii), the same exclusion generally applies with regard to a taxpayer's capital loss.

New subparagraph 39(1)(a)(ii.3) provides a similar exclusion for property in respect of which subsection 94.2(3) applies (and subsection 94.2(20) does not apply) to a taxpayer for a taxation year. Subsection 94.2(3) sets out the conditions for the application of the mark-to-market taxation regime under section 94.2 for participating interests in foreign investment entities. Because of paragraph 94.2(5)(b), this exclusion does not apply in the case of a taxpayer who is not resident in Canada immediately before the time of the disposition.

This amendment applies to dispositions that occur after 2002.

## **Clause 4**

### **Convertible Property**

ITA

51

Section 51 of the Act generally permits a tax-deferred transfer of property where a taxpayer, pursuant to a right of conversion, exchanges capital property (referred to in the commentary on this section as the “convertible property”) that is a share, bond, debenture or note of a corporation for capital property that is another share of the capital stock of the corporation.



ITA  
51(1)(c)

Paragraph 51(1)(c) of the Act provides that, except for the purpose of subsection 20(21), an exchange described in paragraph 51(1)(a) or (b) is deemed not to be a disposition of the convertible property.

Paragraph 51(1)(c) is amended to ensure that an exchange of convertible property will be considered to be a disposition for the purpose of paragraph 94(2)(m) of the Act.

This amendment applies to taxation years that begin after 2002. It also applies to taxation years of a taxpayer that begin

- after 2000 if a trust, to which the taxpayer, directly or indirectly, transferred property in 2001 (or would have so transferred property if new section 94 of the Act applied in 2001), makes a valid election under the coming-into-force provision of new section 94, and
- after 2001 if a trust, to which the taxpayer, directly or indirectly, transferred property in 2002 (or would have so transferred property if new section 94 of the Act applied in 2002), makes a valid election under the coming-into-force provision of new section 94.

ITA  
51(4)

Subsection 51(4) of the Act provides that subsections 51(1) and (2) will not apply to any exchange to which subsection 85(1) or (2) or section 86 applies.

Subsection 51(4) is amended to provide that subsections 51(1) and (2) also will not apply to any exchange of property if that property is, immediately before the exchange, a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified participating interest” in subsection 248(1), see the commentary on that definition.

This amendment applies to exchanges that occur in taxation years that begin after 2002.

## Clause 5

### Cost of Certain Property

ITA  
52(1)

Section 52 of the Act sets out the rules for determining the cost of certain property for the purposes of measuring any gain or loss on its disposition.

Subject to a number of exceptions, subsection 52(1) of the Act applies where a taxpayer acquires property and a particular amount in respect of its value was included in computing the taxpayer's income for a taxation year throughout which the taxpayer was resident in Canada (or in computing a non-resident taxpayer's taxable income earned in Canada under section 115, taxable income under section 114 or an amount from which tax is withheld under Part XIII). In these circumstances, the particular amount is added in determining the cost to the taxpayer of the property for the purposes of determining capital gains and losses in respect of the property.

Where subsection 94.2(3) applies (and subsection 94.2(20) does not apply) to a taxpayer for a taxation year in respect of a property, an amount in respect of the taxpayer's cost of the property may be included under subsection 94.2(4) in computing the taxpayer's income from the property. Subsection 52(1) is amended so that it does not apply to add an amount to the cost to a taxpayer of a property where the amount may have been so included under subsection 94.2(4).

This amendment is made, even though property subject to the mark-to-market rules in subsection 94.2(4) is generally considered not to be capital property (except where subsection 94.2(20) applies), to deal with the situation where it may become at some later time capital property or where it is capital property to which subsection 94.2(20) applied. Subsection 52(1) should not apply to cause a "bump" in the cost of a property in respect of income or gains recognized under subsection 94.2(4) because section 94.2 contains its own rules for making adjustments in respect of such income or gains. For more detail, see the commentary on subsections 94.2(12), (13) and (21), and the definition "deferral amount" in subsection 94.1(1).

For more information on the definitions "participating interest" and "foreign investment entity" and section 94.2, see the commentary on those provisions.

This amendment applies to taxation years that begin after 2002.

## Clause 6

### Adjustments to Cost Base

ITA  
53

Section 53 of the Act sets out rules for determining the adjusted cost base (ACB) of property. Certain adjustments are made under this section. Subsection 53(1) provides for additions in computing the ACB of a property, and subsection 53(2) for deductions in computing the ACB of a property.

ITA  
53(1)(d.1)

Paragraph 53(1)(d.1) of the Act, applied together with existing paragraph 94(5)(a), provides for an addition in computing the adjusted cost base (ACB) to a taxpayer of the taxpayer's capital interest in a trust to which existing paragraph 94(1)(d) applies. Paragraph 53(1)(d.1) is amended to ensure that historical ACB additions are maintained, notwithstanding the replacement of the rules in existing section 94.

This amendment applies to taxation years that begin after 2002.

It also applies to taxation years of a taxpayer that begin

- after 2000 if a trust, in which the taxpayer had a capital interest at any time in 2001, makes a valid election under the coming-into-force provision for new section 94, and
- after 2001 if a trust, in which the taxpayer had a capital interest at any time in 2002, makes a valid election under the coming-into-force provision for new section 94.

ITA  
53(1)(m) and (m.1)

Paragraph 53(1)(m) of the Act provides for an addition in computing the ACB to a taxpayer of “offshore investment fund property” to which existing section 94.1 applies. Paragraph 53(1)(m) is amended to ensure that the historical ACB additions are maintained, notwithstanding the replacement of the rules in existing section 94.1.

Paragraph 53(1)(m) is also amended to provide for an ACB addition in computing the ACB to a taxpayer of a property in respect of which new

subsection 94.1(4) has applied to include in respect of the property an amount in computing the taxpayer's income for a taxation year. For more information, see the commentary on section 94.1.

Paragraph 53(1)(*m.1*) is introduced to provide for the ACB additions contemplated by new subsections 94.2(12) and 94.3(5). For more information, see the commentary on those subsections.

These amendments apply to taxation years that begin after 2002.

ITA

53(2)(*b.1*)

Paragraph 53(2)(*b.1*) of the Act, applied together with existing paragraph 94(5)(*b*), provides for a deduction in computing the ACB to a taxpayer of the taxpayer's capital interest in a trust to which existing paragraph 94(1)(*d*) applies. Paragraph 53(1)(*b.1*) is amended to ensure that historical ACB deductions are maintained, notwithstanding the replacement of the rules in existing section 94.

This amendment applies to taxation years that begin after 2002. It also applies to taxation years of a taxpayer that begin

- after 2000 if a trust, in which the taxpayer had a capital interest at any time in 2001, makes a valid election under the coming-into-force provision for new section 94, and
- after 2001 if a trust, in which the taxpayer had a capital interest at any time in 2002, makes a valid election under the coming-into-force provision for new section 94.

ITA

53(2)(*w*)

Paragraph 53(2)(*w*) of the Act is introduced to provide for the ACB reductions contemplated by new subsections 94.2(12), 94.3(5) and 94.4(2). For more information, see the commentary on those subsections.

New paragraph 53(2)(*w*) applies to taxation years that begin after 2002.



## Clause 7

### Death of a Taxpayer

ITA  
70(3.1)

Under subsection 70(2) of the Act, the value of certain “rights or things” owned by an individual at the time of the individual's death is required to be included in the individual's income for the year of death. Subsection 70(3) provides that this rule does not apply in connection with “rights or things” transferred to beneficiaries of the deceased within a specified period of time. Subsection 70(3.1) provides that certain property does not constitute a “right or thing” for this purpose.

Subsection 70(3.1) is amended so that a “right or thing” does not include property in respect of which new subsection 94.2(3) applied (and subsection 94.2(20) does not apply) for the individual's taxation year in which the individual dies. New subsection 94.2(3) sets out the conditions for the application of the mark-to-market taxation regime under section 94.2 for participating interests in foreign investment entities.

This amendment applies to taxation years that begin after 2002.

ITA  
70(5.2)

Subsection 70(5.2) of the Act provides rules with respect to the disposition of resource properties and land inventories on the death of an individual.

Subsection 70(5.2) is amended so that it also applies to property in respect of which new subsection 94.2(3) applied (and subsection 94.2(20) does not apply) for the individual's taxation year in which the individual dies. With respect to such property, amended paragraph 70(5.2)(a) provides for a deemed disposition, immediately before the death of the individual, for proceeds of disposition equal to the fair market value of the property at that time. New subsection 94.2(3) sets out the conditions for the application of the mark-to-market taxation regime under section 94.2 for participating interests in foreign investment entities.

In the case of a property in respect of which subsection 94.2(3) applied (and subsection 94.2(20) does not apply) for the individual's taxation year in which the individual dies, the proceeds of disposition are included in the value of A in the mark-to-market formula for the

taxation year in respect of the property. This formula applies in computing the deceased's income under subsection 94.2(4) for the taxation year of death. The deceased is treated as not having held the interest after death.

Paragraph 70(5.2)(b) is amended to provide that properties in respect of which a deemed disposition occurs under paragraph 70(5.2)(a) are deemed to have been acquired, by the person who as a consequence of the individual's death acquires the property, at a cost equal to that fair market value.

Where certain resource properties and land inventories held by an individual immediately before death are deemed, under paragraph 70(5.2)(a) and (b), to have been disposed of by the individual and acquired at a particular cost by another person, new paragraph 70(5.2)(c) sets out the conditions under which it will apply, instead of 70(5.2)(a) and (b), to determine the proceeds of disposition and cost of acquisition resulting from that deemed disposition and that acquisition. In particular, where the conditions in paragraph (c) are met, subparagraph 70(5.2)(c)(i) applies to determine the individual's proceeds from the deemed disposition under paragraph (a) of a land inventory or resource property. In turn, subparagraph 70(5.2)(c)(ii) deems the land inventory or resource property to have been acquired at the time of the individual's death at a cost equal to the amount determined under subparagraph (i) in respect of the deemed disposition of the property under paragraph 70(5.2)(a).

This amendment applies to taxation years that begin after 2002.

## **Clause 8**

### ***Inter Vivos Transfers by Individuals***

#### **ITA 73(1)**

Subsection 73(1) of the Act generally provides for a tax-deferred disposition of capital property by an individual (other than a trust) where it is transferred by the individual in circumstances where subsection 73(1.01) applies and a number of other conditions are met.

Subsection 73(1) is amended so that it does not apply to a transfer of property that is a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition "specified participating interest" in subsection 248(1), see the commentary on that definition.



This amendment applies to transfers that occur in taxation years that begin after 2002.

## **Clause 9**

### **Trusts – Attribution**

ITA  
75(2) and (3)

Subsection 75(2) of the Act generally provides for the attribution of income derived from certain trust property to a person resident in Canada where the property was received by the trust from the person and can revert to the person (or pass to other persons determined by that person). Subsection 75(3) exempts certain trusts from this attribution rule.

Subsection 75(2) is amended to ensure that, if the person to whom income from a particular property would otherwise be attributed under that subsection is an otherwise non-resident trust that is deemed by new subsection 94(3) to be resident in Canada, the income from that property will not be attributed back to the person.

Amended subsection 75(2) generally applies to trust taxation years that begin after 2000.

Subsection 75(3) is amended by adding new paragraph 75(3)(c.2). New paragraph 75(3)(c.2) ensures that subsection 75(2) does not apply to trusts in respect of which the contributors are recent immigrants to Canada (i.e., resident in Canada for not more than 60 months). The exception is consistent with similar 60-month exemptions in:

- section 94 (see subsection 94(3) and the definitions “connected contributor” and “resident contributor” in subsection 94(1)),
- section 94.1 (see subsection 94.1(3) and the definition “exempt taxpayer” in subsection 94.1(1)), and
- section 94.2 (see subparagraph 94.2(11)(c)(i)).

New paragraph 75(3)(c.2) applies to trust taxation years that begin after 2000 except that, for trust taxation years that begin in 2001 or 2002, paragraph 75(3)(c.2) applies with reference to subsection 94(1) as it reads in its application to taxation years that begin after 2002.

## **Clause 10**

### **Definition of “Eligible Property”**

ITA

85(1.11)

Subsection 85(1.1) of the Act describes the types of property (referred to as “eligible property”) that may be transferred to a corporation under subsection 85(1). Subsection 85(1.11) provides that certain foreign resource property (or an interest in a partnership that derives all or part of its value from one or more foreign resource properties) is not an “eligible property” of a taxpayer in respect of a transfer to a corporation.

Subsection 85(1.11) is amended to provide that a specified participating interest is not an eligible property of a taxpayer in respect of a transfer to a corporation. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified participating interest” in subsection 248(1), see the commentary on that definition.

This amendment applies to taxation years that begin after 2002.

## **Clause 11**

### **Share-for-Share Exchange**

ITA

85.1(4) and (6)

Subsection 85.1(3) of the Act permits a taxpayer to transfer, on a tax-deferred “rollover” basis, the shares of a foreign affiliate of the taxpayer to another foreign affiliate of the taxpayer. Subsection 85.1(5) provides a similar rollover for shareholders who exchange shares of a foreign corporation for shares of another corporation. Subsections 85.1(4) and (6), respectively, identify circumstances in which subsection 85.1(3) or (5) will not apply.

Subsection 85.1(4) is amended to provide that subsection 85.1(3) does not apply to a disposition at any time by a taxpayer of a property that is a specified participating interest. Subsection 85.1(6) is similarly amended so that subsection 85.1(5) does not apply to an exchanged share that is, immediately before the exchange, a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified

participating interest” in subsection 248(1), see the commentary on that definition.

These amendments apply to dispositions and exchanges that occur in taxation years that begin after 2002.

## **Clause 12**

### **Share-for-Share Exchange – Reorganization of Capital**

ITA  
86(3)

Subsection 86(1) applies where a corporation reorganizes its capital structure by issuing shares to a taxpayer as full or partial consideration for the surrender of all of the taxpayer’s shares of the capital stock of the corporation. Where this is the case, the cost of the new shares is determined with reference to the adjusted cost base of the surrendered shares. Subsection 86(3) provides that subsection 86(1) does not apply in any case where subsection 85(1) or (2) applies.

Subsection 86(3) is amended to provide that subsection 86(1) also does not apply to any disposition of property that is, immediately before the disposition, a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified participating interest” in subsection 248(1), see the commentary on that definition.

**This amendment applies to** dispositions that occur in taxation years that begin after 2002.

## **Clause 13**

### **Amalgamations – Non-resident Trusts and Foreign Investment Entities**

ITA  
87(2)(j.95)

Section 87 of the Act sets out rules that apply on the amalgamation of two or more taxable Canadian corporations. The amalgamated corporation is generally treated as a continuation of the predecessor corporations for the purposes of the Act.

New paragraph 87(2)(j.95) provides that, where there has been an amalgamation of two or more taxable Canadian corporations, the

amalgamated corporation is deemed to be a continuation of its predecessor corporations for the purposes of sections 94 to 94.4, which relate to foreign trusts and foreign investment entities. Thus, for example, an amalgamated corporation will be considered to be a “contributor” (as defined in subsection 94(1)) to a trust if any predecessor corporation was a contributor to the trust. In addition, the new corporation's “deferral amount” (as defined in subsection 94.2(1)) in respect of an interest in a foreign investment entity will be determined in the same manner as a predecessor's “deferral amount” in respect of the same interest.

Because of the operation of paragraph 88(1)(e.2), new paragraph 87(2)(j.95) also applies to windings-up to which section 88 applies.

This amendment applies to taxation years that begin after 2000.

## **Clause 14**

### **Amounts to be Included in Respect of**

#### **Share of a Foreign Affiliate**

ITA

91

Section 91 of the Act sets out rules for determining amounts that a taxpayer resident in Canada is to include in computing its income for a particular year as income from a share of a controlled foreign affiliate of the taxpayer.

ITA

91(1)

Subsection 91(1) of the Act provides that a taxpayer that is resident in Canada must include in computing income an amount in respect of each share owned by the taxpayer of the capital stock of a controlled foreign affiliate of the taxpayer.

Subsection 91(1) is amended so that it does not result in additional income for a taxpayer arising because of the ownership by the taxpayer (or by a controlled foreign affiliate of the taxpayer) of shares that are participating interests in a “tracking entity” to which the imputed income regime under section 94.1 or the mark-to-market regime under section 94.2 applies by reason of the application of subsection 94.2(9). The shares of a taxpayer in the capital stock of a corporation that is a controlled foreign affiliate of the taxpayer will generally be treated as “exempt interests” (as defined in new subsection 94.1(1)), and therefore



not subject to the income inclusions under subsections 94.1(4) or 94.2(4) of the Act. However, if subsection 94.2(9) applies in respect of those shares (in particular, note that paragraph 94.2(9)(b) does not exclude the application of subsection 94.2(9) to an exempt interest that is an interest in a controlled foreign affiliate) either of subsections 94.1(4) or 94.2(4) will apply generally to require an amount to be included in computing the income of the taxpayer. Because of subparagraph 94.3(2)(b)(i), the accrual regime in section 94.3 will not apply in respect of an interest to which subsection 94.2(9) applies.

For more details on the application of sections 94.1 to 94.4, see the commentary on those provisions.

This amendment applies to taxation years that begin after 2002.

#### ITA 91(4)

Subsection 91(4) of the Act provides for a deduction in computing the income of a taxpayer resident in Canada. The deduction is available where the taxpayer has included an amount under subsection 91(1) in computing income in respect of a share of the capital stock of a controlled foreign affiliate of the taxpayer. The deduction is generally determined with reference to foreign taxes payable by the affiliate and a “relevant tax factor”. The “relevant tax factor” for a resident taxpayer is designed to permit a deduction for the resident taxpayer that will result in tax relief that is a proxy for a foreign tax credit in respect of foreign taxes payable by a controlled foreign affiliate of the resident taxpayer.

Subsection 91(4) is amended to explicitly link the “relevant tax factor” to the resident taxpayer and the taxation year for which the deduction under subsection 91(4) is claimed. For more detail on the definition “relevant tax factor” in subsection 95(1), see the commentary on that provision.

This amendment applies to the 2002 and subsequent taxation years.

## Clause 15

### Non-resident Trusts

ITA

94

## OVERVIEW

### *Existing Rules*

Section 94 of the Act sets out rules that tax the passive income earned by certain non-resident trusts. Section 94 generally applies if a person resident in Canada has transferred or loaned property to a non-resident trust that has one or more beneficiaries that are resident in Canada.

Section 94 uses two different methods to impose tax, depending on whether the trust is a discretionary trust. A discretionary trust is a trust under which a person has a discretionary power to determine the amount of the income or capital of the trust that one or more beneficiaries will receive.

If the non-resident trust is a discretionary trust, paragraph 94(1)(c) deems the trust to be resident in Canada for the purposes of Part I of the Act and deems its income for tax purposes to be the total of its Canadian source income and its foreign accrual property income, if any. Each beneficiary is jointly and severally liable to pay the Canadian tax of the trust. However, the liability can be enforced against a particular beneficiary only to the extent that the beneficiary has received a distribution from the trust or proceeds from the sale of an interest in the trust.

If the non-resident trust is not a discretionary trust, paragraph 94(1)(d) provides that it is to be treated in much the same manner that a non-resident corporation is treated. If a Canadian resident beneficiary holds an interest in the trust with a fair market value equal to 10% or more of the total fair market value of all beneficial interests in the trust, the trust is deemed to be a controlled foreign affiliate of the beneficiary. Consequently, the foreign accrual property income rules apply to the trust and the beneficiary, requiring the beneficiary to include a portion of the foreign accrual property income of the trust in income. On the other hand, beneficiaries whose beneficial interests are less than 10% of the total fair market value of all interests in the trust may be subject to tax under the offshore investment fund rules in section 94.1. If section 94.1 does not apply, such beneficiaries are taxed only if trust income becomes payable to them in the year in which it arises.



## *New Rules*

New section 94 of the Act takes a different approach to the taxation of non-resident trusts (NRTs). In general, if a Canadian resident contributes property to a NRT, the contributor, the NRT and certain Canadian resident beneficiaries of the trust may all become jointly and severally, or solidarily, liable to pay Canadian tax on the world-wide income of the trust. (The English-language expression “jointly and severally” no longer exists in the civil law of the province of Quebec and has been replaced in that civil law with the expression “solidarily”. In the English-language version of section 94, the expression “solidarily” is added to the expression “jointly and severally”, which latter expression is maintained for common-law purposes. The French-language version of new section 94 uses only the expression “*solidaire*” as this expression is appropriate for both the civil and common-law. These changes ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.)

Except as indicated otherwise, the amendments to section 94 apply to trust taxation years that begin after 2002. In addition,

- a trust created in 2001 may elect in writing (by filing the election with the Minister on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2001 and 2002, and
- a trust created in 2002 may elect in writing (by filing the election with the Minister on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2002.

The table next page briefly summarizes section 94 and related rules.

Issue	Summary	References
1. Which trusts are subject to the new NRT rules?	<p>A. In general, a trust (other than an exempt foreign trust) will be subject to tax for a taxation year as a trust resident in Canada if a contribution was made to the trust by an entity (other than a recent immigrant to Canada) that is resident in Canada at a specified time (generally, the end of the year).</p>	<p>S. 94(3)</p> <p>“entity” – s. 94(1)</p> <p>“exempt foreign trust” – s. 94(1)</p> <p>“contribution” – s. 94(1) and (2)</p> <p>“resident contributor” – s. 94(1)</p> <p>“specified time” – s. 94(1)</p>
	<ul style="list-style-type: none"> <li>• B. In addition, a trust (other than an exempt foreign trust) will generally be subject to Canadian tax for a taxation year if there is a resident beneficiary under the trust. More specifically if:</li> <li>• the contribution was made by an entity when the entity was resident in Canada (or generally within a 60-month period before the entity became resident in Canada or within a 60-month period after the entity ceased to be resident in Canada),</li> </ul>	<p>S. 94(3) and (10)</p> <p>“beneficiary” – s. 94(1)</p> <p>“contribution” – s. 94(1) and (2)</p> <p>“connected contributor” – s. 94(1)</p> <p>“entity” – s. 94(1)</p> <p>“non-resident time” – s. 94(1)</p> <p>“resident beneficiary” – s. 94(1)</p> <p>“specified charity” – s. 94(1)</p> <p>“specified time” – s. 94(1)</p> <p>“testamentary beneficiary” – s. 94(1)</p>

Issue	Summary	References
	<ul style="list-style-type: none"> <li>• where the contributing entity is an individual (other than a trust), at the specified time the individual had been resident in Canada for more than 60 months, and</li> <li>• at the specified time there is an entity (other than a specified charity or testamentary beneficiary) that is resident in Canada and is a beneficiary under the trust.</li> </ul>	
2. Who is responsible for the tax payable by an NRT?	<p>The trust is required to pay tax. If it fails to do so, each contributor referred to in 1(A) and/or each beneficiary referred to in 1(B) is jointly and severally or solidarily liable with the trust for the tax. However, the amount recoverable from an entity that is simply a beneficiary is limited to the beneficiary's recovery limit. Relief is also available in some cases for a contributor whose contribution to the trust is insignificant relative to other contributions made to the trust.</p>	<p>Jointly and severally, or solidarily, liable: paragraph 94(3)(d)</p> <p>Limit to amount recoverable - 94(7)</p> <p>Recovery limit - 94(8)</p> <p>Determination of fair market value - 94(9)</p> <p>Definitions - 94(1)</p>
3. Where the NRT rules apply to a trust for a taxation year, how will the trust's tax liabilities be calculated?	A. Canadian rules generally apply to the trust as if the trust were resident in Canada throughout the year for the purpose of computing the trust's income.	s. 94(3)

Issue	Summary	References
	B. Explicit rule treats the trust as becoming resident in Canada, with resulting adjustment to cost amount of property.	s. 94(3)(c); 94(4)(d), 128.1(1)
	C. Parts XII.2 and XIII do not apply to the trust. Explicit exemption from Part XIII tax on amounts distributed to the trust, although payer must still withhold.	s. 94(3)(a)(vii) and (viii) and (4)(c) and 215 and 216(4.1)
	D. Flow-through of income to resident and non-resident beneficiaries permitted, subject to special rules in the event that Canadian-source income is distributed to non-residents.	s. 94(3)(a)(viii) and 104(7.01) - special rules

## Definitions

ITA  
94(1)

New subsection 94(1) of the Act defines a number of expressions that apply for the purpose of section 94.

### “arm's length transfer”

A loan or transfer of property by an “entity” in respect of a trust will generally not be considered a “contribution” to the trust where the loan or transfer is an “arm's length transfer”. In these circumstances, the transferor entity will not, because of that loan or transfer, be considered to be a “contributor” to the trust. Accordingly, subsection 94(3) does not apply to a non-resident trust as a consequence only of an “arm's length transfer” in respect of the trust. (For more information on the definitions “contribution”, “contributor” and “entity” in subsection 94(1), see the commentary on those definitions.)

The definition “arm's length transfer” also is relevant in applying the rules in new paragraphs 94(2)(a) and (c). Under those rules, a loan or

transfer of property made to an entity other than a particular trust may, in specified circumstances, result in a transfer of property being considered to have been made to the particular trust. (For more information, see the commentary on new subsection 94(2).)

If property transferred or loaned is “restricted property”, the transfer or loan will not be an arm’s length transfer. (For more information on the definition “restricted property”, see the commentary on that definition.)

Under paragraph (a) of the definition, a transfer or loan will be an arm’s length transfer only if it is reasonable to conclude that none of the reasons (determined by reference to all the circumstances including the terms of a trust, an intention, the laws of a country or the existence of an agreement, a memorandum, a letter of wishes or any other arrangement) for the transfer is the acquisition at any time by any entity of an interest as a beneficiary under a non-resident trust.

Under subparagraphs (b)(i) and (ii) of the definition, an arm's length transfer includes, in general terms, an arm's length return on investment (conferred by the entity in which the investment is made) and certain payments made by a corporation on a reduction of the paid up capital in respect of shares of a class of the corporation's capital stock.

Under subparagraph (b)(iii) of the definition, an arm's length transfer includes a transfer to a trust by a “specified charity” (as defined in new subsection 94(1)) in respect of the trust that is made by the specified charity for the purpose of refunding in whole or in part a gift previously made to the specified charity entity by the trust. For more information on the definition “specified charity”, see the commentary on that definition.

Under subparagraph (b)(iv) of the definition, an arm's length transfer includes a transfer in exchange for which, the recipient transfers or loans property (other than a restricted property) to the transferor, or becomes obligated to so transfer or loan such property, and for which it is reasonable to conclude

- having regard only to the transfer and the exchange that the transferor would have been willing to make the transfer if the transferor dealt at arm's length with the recipient, and
- that the terms and conditions, and circumstances, under which the transfer was made would have been acceptable to the transferor if the transferor dealt at arm's length with the recipient,



Under subparagraph (b)(v) of the definition, an arm's length transfer includes a transfer that is made in satisfaction of an obligation that arose because of a transfer to which subparagraph (b)(iv) applied, if

- the transfer is not a transfer described in paragraph 94(2)(g),
- the transferor would have been willing to make the transfer if the transferor dealt at arm's length with the recipient, and
- the terms and conditions, and circumstances, under which the transfer was made would have been acceptable to the transferor if the transferor dealt at arm's length with the recipient.

Under subparagraph (b)(vi) of the definition, an arm's length transfer includes a transfer that is a payment of an amount owing by the transferor under a written agreement the terms and conditions of which, when entered into, were terms and conditions that, having regard only to the amount owing and the agreement, persons dealing at arm's length would have entered into, if the transfer is not a transfer described in paragraph 94(2)(g).

Under subparagraph (b)(vii) of the definition, an arm's length transfer includes a transfer that is a payment made before 2002 to a trust (or to a corporation controlled by the trust or to a partnership of which the trust is a majority interest partner, together referred to in this subparagraph as "the specified person or partnership") in repayment of or otherwise in respect of a particular loan made by the trust (or by the specified person or partnership, as the case may be) to the transferor.

Finally, under subparagraph (b)(viii) of the definition, an arm's length transfer includes a transfer that is a payment made after 2001 to a trust (or to a corporation controlled by the trust or to a partnership of which the trust is a majority interest partner, together referred to in this subparagraph as "the specified person or partnership") in repayment of or otherwise in respect of a particular loan made by the trust (or by the specified person or partnership, as the case may be) to the transferor in circumstances where either

- they would have been willing to enter the particular loan if they dealt at arm's length with each other and the payment is not a transfer described in paragraph 94(2)(g), or



- the payment is made before 2005 in accordance with fixed repayment terms agreed to before June 23, 2000.

The definition “arm's length transfer” generally applies to trust taxation years that begin after 2002. However, where a trust elects, by notifying the Minister in writing on or before its filing-due date for its taxation year that includes the day on which this Act is assented to, the definition “arm's length transfer” will be read without reference to a loan or transfer of property that is made before 2003 and identified in the election. This electing provision recognizes that the definition “arm's length transfer” in the new rules does not have an equivalent under existing subsection 94(1) of the Act. In particular, a non-resident trust now considered resident by reason of existing subsection 94(1) might not be described in new subsection 94(3) and would no longer be considered resident, which would result in the change in residency rules in subsection 128.1(4) applying. The election, which is found in the coming-into-force provision of the amending legislation, effectively permits a trust to continue to be deemed resident.

### **“beneficiary”**

Under paragraph (a) of the new definition “beneficiary” in subsection 94(1), a beneficiary under a trust includes an entity beneficially interested in the trust.

Under paragraph (b) of that definition, a beneficiary under a trust also includes an entity that would be beneficially interested in the trust if

- the entity were a person, and
- the reference in subparagraph 248(25)(b)(ii) to

(A) “any arrangement in respect of the particular trust” were read as a reference to “any arrangement (including the terms or conditions of a share, or any arrangement in respect of a share, of the capital stock of a corporation that is beneficially interested in the particular trust) in respect of the particular trust”, and

(B) “the particular person or partnership might” were read as a reference to “the particular person or partnership becomes (or could become on the exercise of any discretion by any entity), directly or indirectly, entitled to any amount derived, directly or indirectly, from the income or capital of the particular trust or might”.

For the purposes of the Act, the expression “beneficially interested” has the meaning assigned by subsection 248(25) of the Act.

### **“closely-held corporation”**

The definition “closely-held corporation” is relevant in applying subparagraph (b)(i) of the definition “arm’s length transfer” and the definition “restricted property”. (For more information on the definitions “arm’s length transfer” and “restricted property” in subsection 94(1), see the commentary on those definitions.)

A closely-held corporation at any time, means a corporation, other than a corporation in respect of which

- there is at least one class of shares of its capital stock that class is not a specified class (within the meaning assigned by subsection 256(1.1),
- it is reasonable conclude that at that time the shares of those classes (other than such a specified class) are held by at least 150 entities each of whom holds shares that have a total fair market value of at least \$500, and
- it is reasonable conclude that the total number of issued and outstanding shares of a class (other than such a specified class) held by a particular entity or by any other entity with whom the particular entity does not deal at arm’s length is not more than 10% of the total number of the issued and outstanding shares of that class.

Subsection 94(16) is an anti-avoidance provision that applies in determining whether a corporation is a closely-held corporation at any time. For more detail, see the commentary on that provision.

### **“connected contributor”**

The definition “connected contributor” is relevant in determining whether a beneficiary is, at a particular time, a “resident beneficiary” (as defined in new subsection 94(1)) under a non-resident trust. Under new paragraph 94(3)(d) of the Act, such a resident beneficiary can, to an extent, be liable for the trust’s income tax. For more information, see the commentary on subsections 94(3) and (7) to (10), subparagraph 152(4)(b)(vi) and subsections 160(2.1) and (3).

A connected contributor at a particular time is any entity, including an entity that has ceased to exist, that is a “contributor” (as defined in new subsection 94(1)) to the trust at that time, other than

- an individual who was resident in Canada for a period of, or periods the total of which is, not more than 60 months (but not including a trust or an individual who before that time was never non-resident), or
- an entity that is a contributor only because of one or more transactions that occurred at a “non-resident time” (as defined in new subsection 94(1)) of the entity.

For more information on the definitions “contributor”, “resident beneficiary” and “non-resident time” in subsection 94(1), see the commentary on those definitions.

In the context of the definition “connected contributor”, reference should also be made to new paragraphs 94(2)(a) to (m) (which extend the circumstances in which a transfer is considered to occur for the purposes of section 94), new paragraphs 94(2)(n) to (q) and subsections 94(11) to (13) (which generally extend the circumstances in which a contribution is considered to be made for the purposes of section 94) and paragraphs 94(2)(r) to (u) (which generally narrow the circumstances in which a contribution is considered to be made for the purposes of section 94). Reference should also be made to new subsection 94(10), which applies where a contributor becomes resident in Canada within 60 months after making a contribution to a trust.

### **“contribution”**

Where a “contribution” is made at or before a particular time to a non-resident trust by an entity, that entity will be considered to be a “contributor” at the particular time and, in certain cases, will be jointly and severally or solidarily liable under subsection 94(3) for the trust's income taxes. (For more detail on the expression “solidarily”, please refer to the introductory commentary above on new section 94.) For more information on subsection 94(3), see the commentary on that subsection.

Under paragraph (a) of the definition, a “contribution” to a trust by a particular entity means a loan or transfer of property (in this commentary referred to as a “transfer”) by the entity to the trust (other than an “arm's length transfer”, as defined in new subsection 94(1)).

Under paragraphs (b) and (c) of the definition “contribution”, a contribution is also considered to have been made by a particular entity where

- the particular entity makes a particular transfer (other than an “arm’s length transfer”) as part of a series of transactions or events that includes another transfer (other than an arm’s length transfer), to the trust, by another entity; or
- the particular entity becomes obligated to make a particular transfer (other than a transfer that would, if it were made, be an “arm’s length transfer”) as part of a series of transactions or events that includes another transfer (other than an arm’s length transfer), to the trust, by another entity.

In these circumstances, the other transfer is considered to be a contribution to the trust by the particular entity only to the extent that the other transfer can reasonably be considered to have been made in respect of the particular transfer or the particular entity’s obligation to make the particular transfer, as the case may be. In either case, a contribution is considered to be made at the time of the other transfer.

There are a number of rules that have the effect of applying the definition “contribution” more broadly than would otherwise be the case. See the commentary on new paragraphs 94(2)(a) to (m) (which extend the circumstances in which a transfer is considered to occur for the purposes of section 94), new paragraphs 94(2)(n) to (q) and subsections 94(11) to (13) (which generally extend the circumstances in which a contribution is considered to be made for the purposes of section 94) and paragraphs 94(2)(r) to (u) (which generally narrow the circumstances in which a contribution is considered to be made for the purposes of section 94).

The definition “contribution” applies to all loans and transfers, irrespective of when made.

### **“contributor”**

A “contributor” to a trust at any time means an “entity” (as defined in new subsection 94(1)), including an entity that has ceased to exist, that at or before that time has made a “contribution” (as defined in new subsection 94(1)) to the trust. The definition “contributor” is significant primarily for the purposes of the definitions “resident contributor” and



“connected contributor” in new subsection 94(1). For more information, see the commentary on those definitions.

Reference should be made in this context to new paragraphs 94(2)(a) to (m) (which extend the circumstances in which a transfer is considered to occur for the purposes of section 94), new paragraphs 94(2)(n) to (q) and subsections 94(11) to (13) (which generally extend the circumstances in which a contribution is considered to be made for the purposes of section 94) and paragraphs 94(2)(r) to (u) (which generally narrow the circumstances in which a contribution is considered to be made for the purposes of section 94).

### **“eligible non-resident trust”**

An “eligible non-resident trust” can qualify as an exempt foreign trust under paragraph (h) of the definition “exempt foreign trust” where it meets the conditions imposed by that paragraph.

An eligible non-resident trust at any time means a trust other than a trust that

- is created or maintained for charitable purposes,
- is governed by an employee benefit plan,
- is described in paragraph (a.1) of the definition “trust” in subsection 108(1),
- is governed by a salary deferral arrangement,
- is operated for the purpose of administering or providing superannuation, pension, retirement or employee benefits,
- was ever a personal trust, or
- has elected in writing filed with the Minister in a timely fashion that the definition “exempt foreign trust” not apply to it.

### **“entity”**

The expression “entity” is defined to include an association, a corporation, a fund, a natural person, a joint venture, an organization, a partnership, a syndicate and a trust.

### **“exempt foreign trust”**

An “exempt foreign trust” includes a number of different types of non-resident trusts that are exempt from the application of new subsection 94(3). The expression refers to the following types of non-resident trusts:

(a) a non-resident trust the current income (determined with reference to amended subsection 108(3)) or capital from which can be provided only to one or more physically or mentally infirm dependent individuals, provided that these individuals are non-resident and that any property settled on the trust could reasonably be considered, at the time it was settled, to be necessary for the maintenance of those individuals;

(b) a non-resident trust created after the breakdown of a marriage or common-law partnership of two individuals, the current income (determined with reference to amended subsection 108(3)) or capital from which can be provided only to non-resident children of one of the individuals, if the children are under 21 years of age (or under 31 years of age and enrolled in a specified educational institution) and each “contribution” to the trust (as defined in subsection 94(1)) was to provide for the maintenance of those children;

(c) certain non-resident trusts that own or administer a university described in paragraph (f) of the definition “total charitable gifts” in subsection 118.1(1) and that could qualify under that definition as a recipient permitted for the purposes of the tax credit for charitable gifts;

(d) certain non-resident trusts established exclusively for charitable purposes (as those purposes are defined in the laws of Canada);

(e) a non-resident trust that is governed by an employee profit sharing plan (as defined in subsection 248(1)), by a retirement compensation arrangement (as defined in subsection 248(1), or by a foreign retirement arrangement (as defined in subsection 248(1));

(f) a non-resident trust that is governed by an employee benefit plan (as defined in subsection 248(1)) or a trust described in paragraph (a.1) of the definition trust in subsection 108(1), if

(i) it is maintained primarily for the benefit of non-resident individuals,

(ii) it holds no restricted property,

(iii) it provides no benefits, other than benefits in respect of services described in clauses (iv)(A) to (D) of the definition;

(g) a non-resident trust that has been operated exclusively for the purpose of administering or providing superannuation, pension, retirement or employee benefits, if it meets the conditions stipulated under paragraph (g) of the definition regarding its beneficiaries (and their rights), its property, its jurisdiction of residence, and its liability for tax under the laws of that jurisdiction.

(h) a non-resident trust that is an eligible non-resident trust if the only beneficial interests in the trust are “specified fixed interests” (as defined in subsection 94(1)) and, in general terms,

(i) where there are at least 150 beneficiaries (determined without reference to subsection 248(25) of the Act) under the trust each of whom holds a specified fixed interest in the trust worth at least \$500, the only “resident contributors” (as defined in subsection 94(1)) to the trust that hold more than 10% of the issued interests of any class of beneficial interests in the trust are “specified contributors” (as defined in subsection 94(1)) to the trust, or

(ii) in any other case, each resident contributor to the trust is a specified contributor to the trust and a copy of the current terms of the trust (and any other required information in prescribed form) has been filed with the Minister of National Revenue by or on behalf of the trust.

(i) a prescribed trust or prescribed class of trusts. (At the present time, it is not anticipated that any trust or class of trusts will be prescribed for this purpose).

Paragraph (h) is intended to apply to non-resident investment trusts that are legitimately commercial. Such a trust is intended to be treated as a foreign investment entity under sections 94.1 to 94.4 of the Act. A Canadian resident investor (other than an “exempt taxpayer” within the meaning assigned by subsection 94.1(1)) in the trust would be expected to be a taxpayer to whom subsection 94.1(3) or 94.2(9) applies for a taxation year of the investor in respect of their investment in the trust.

**“exempt service”**

The definition “exempt service” is relevant to new paragraph 94(2)(f), which deems the provision of certain services (other than exempt services) to be a transfer of property.

An exempt service means a service rendered at any time by an entity (the “service provider”) to, for or on behalf of, another entity (a “recipient”) if either

- the recipient is at that time a trust and the service relates to the administration of the trust, or
- the following conditions apply in respect of the service, namely
  - (i) the service is rendered in the service provider's capacity at that time as an employee or agent of the recipient,
  - (ii) in exchange for the service the recipient transfers or loans property, or becomes obligated to transfer or loan property, and
  - (iii) it is reasonable to conclude
    - (A) having regard only to the service and the exchange that the service provider would have been willing to carry out the service if the service provider had dealt at arm's length with the recipient, and
    - (B) that the terms and conditions, and circumstances, under which the service was provided would have been acceptable to the service provider if the service provider had dealt at arm's length with the recipient.

**“exempt taxpayer”**

The definition “exempt taxpayer” is relevant in determining whether a taxpayer is a “specified contributor” to a trust.

Except as indicated below, tax-exempt persons to which subsection 149(1) applies are generally exempt taxpayers. However, retirement compensation arrangements and qualifying environmental trusts for which alternative income tax rules are provided under Parts XI.3 and XII.4, and insurers to which paragraph 149(1)(t) applies, are not exempt taxpayers.



An exempt taxpayer also includes a Canadian resident pooled fund trust under which the only beneficiaries (determined without reference to subsection 248(25) of the Act) are the tax-exempt persons described above that would qualify as exempt taxpayers with respect to another entity if they held their interests directly in that other entity. However, such a pooled fund trust will qualify as an exempt taxpayer only if all of the interests in the trust are “specified fixed interests”.

### **“non-resident time”**

The definition “non-resident time” is relevant in determining whether a contributor to a trust is a “connected contributor” and whether the “look-through” rule in paragraph 94(2)(l) applies in determining whether an entity has made a contribution (i.e., is a contributor).

The “non-resident time” of an entity in respect of a particular time means a time (referred to in this commentary as the “contribution time”) at which the entity made a contribution to a trust, that is before the particular time and at which the entity was non-resident, provided that the entity was non-resident (or not in existence) throughout a specified period.

As indicated into the coming-into-force provision for new section 94 of the Act, where the contribution time occurs before June 23, 2000, the specified period is the period that begins 18 months before the end of the trust’s taxation year that includes the contribution time and ends at the earliest of

- 60 months after the contribution time;
- where the entity is an individual, the date of the individual's death; and
- the particular time.

Where the contribution time occurs after June 22, 2000 and the trust arose on and as a consequence of the death of an individual, the specified period is the period that begins 18 months before the contribution time and ends at the earliest of

- 60 months after the contribution time;
- where the entity is an individual, the date of the individual's death; and
- the particular time.

Where the contribution time occurs after June 22, 2000 and the trust did not arise on and as a consequence of the death of an individual, the specified period is the period that begins 60 months before the contribution time and ends at the earliest of

- 60 months after the contribution time;
- where the entity is an individual, the date of the individual's death; and
- the particular time.

The measurement of the specified period by reference to any particular time is to ensure that the contributing entity and the trust may treat the contribution time as a “non-resident time” for the purposes of applying subsection 94(3) at a “specified time” in respect of the trust for a taxation year of the trust (generally, the end of that taxation year) if at the end of that particular year the contributor still has not become resident in Canada within the 60-month period after the contribution time.

However, new subsection 94(10) ensures that such a contributor will, for the purposes of the definition “connected contributor”, be considered to have made the contribution at a time other than a “non-resident time” if the contributor becomes resident in Canada within the 60-month period after the contribution time. As a result, at each “specified time” in respect of the trust for taxation year of the trust (generally, the end of that taxation year) following the contribution, there would be a connected contributor to the trust and, if there were a resident beneficiary under the trust, subsection 94(3) would also apply in respect of those years.

Amended subparagraph 152(4)(b)(vi) of the Act ensures that a reassessment of a taxpayer arising out of the application of subsection 94(10) may be undertaken by the Canada Customs and Revenue Agency within 3 years after the end of the taxpayer's normal reassessment period for the taxpayer's relevant taxation year.

For more information on new subsection 94(10) and amended subparagraph 152(4)(b)(vi), see the commentary on those provisions.

## **“promoter”**

The definition “promoter” is relevant in applying new paragraph 94(2)(s), which provides that a transfer to a trust will not be considered a contribution where certain conditions, described in that paragraph, are met. For this purpose a promoter means an entity that establishes, organizes or substantially reorganizes the undertakings of the trust. For more information on paragraph 94(2)(s), see the commentary on that paragraph.

## **“resident beneficiary”**

Under new subsection 94(3), a particular trust is generally treated as resident in Canada for a particular taxation year of the trust if there is a “resident beneficiary” under the particular trust at a “specified time” (generally, the end of the particular year). Under new paragraph 94(3)(d), each “resident beneficiary” can be jointly and severally or solidarily liable with the particular trust for the particular trust's income tax liabilities under the Act for the particular year. (For further information with respect to the expression “solidarily”, please refer to the introductory commentary on new section 94.) See also the commentary on subsection 94(3).

A “resident beneficiary” at a particular time under a trust is an entity (other than an entity that is at that time a “specified charity” or a “testamentary beneficiary” in respect of the trust) that, at that time, is a beneficiary under the trust, if, at that time,

- the entity is resident in Canada; and
- there is a “connected contributor” to the trust.

The expressions “connected contributor”, “specified charity” and “testamentary beneficiary” are defined in new subsection 94(1). For further information, see the commentary on those definitions.

## **“resident contributor”**

Under new subsection 94(3), a trust is generally treated as resident in Canada for a particular taxation year of the trust if there is a “resident contributor” to the trust at a “specified time” in respect of the trust for the particular taxation year (generally, the end of the particular year). Under new paragraph 94(3)(d), a “resident contributor” can be jointly and severally or solidarily liable with the trust for the trust's income tax

liabilities under the Act for the particular year. (For further information with respect to the expression “solidarily”, please refer to the introductory commentary above on new section 94.)

A “resident contributor” at any time means an entity that is, at that time, resident in Canada and a “contributor” (as defined in new subsection 94(1)) to the trust. However, an exemption from treatment as a resident contributor is provided for a contributor who is:

- an individual who was resident in Canada for a period of, or periods the total of which is, not more than 60 months (but not including a trust or an individual who before that time was never non-resident); and
- an individual, if the trust is an *inter vivos* trust that was created before 1960 by a person who was non-resident when the trust was created and the individual made no contribution after 1959 to the trust.

In the context of this definition, reference should also be made to new paragraphs 94(2)(a) to (m) (which extend the circumstances in which a transfer is considered to occur for the purposes of section 94), new paragraphs 94(2)(n) to (q) and subsections 94(11) to (13) (which generally extend the circumstances in which a contribution is considered to be made for the purposes of section 94) and paragraphs 94(2)(r) to (u) (which generally narrow the circumstances in which a contribution is considered to be made for the purposes of section 94).

### **“restricted property”**

The expression “restricted property” is relevant in applying a number of provisions in respect of non-resident trusts, including the definitions in subsection 94(1) of “arm’s length transfer” and “exempt foreign trust”. The definition “restricted property” is intended to serve as an anti-avoidance provision.

More specifically, restricted property means

- under paragraph (a) of the definition, a particular share (or a right to acquire a share) of the capital stock of a particular closely-held corporation if the particular share (or right), or a property for which the particular share (or right) was substituted, was at any time acquired as part of a transaction or series of transactions under which a specified share of the capital stock of a closely-held



corporation was acquired by any entity in exchange for, as consideration for, or upon conversion of any property;

- under paragraph (b) of the definition, an indebtedness (or a right to acquire indebtedness) owing by another entity if
  - the other entity is a closely-held corporation,
  - the indebtedness (or right), or a property for which the indebtedness (or right) was substituted, was at any time acquired as part of a transaction or series of transactions under which a specified share of the capital stock of a closely-held corporation was acquired by any entity in exchange for, as consideration for, or upon conversion of any property, and
  - the amount of any payment (under a right to receive, in any manner whatever and from any entity, amounts in respect of the indebtedness), or the value of such a right, is, directly or indirectly, determined primarily by reference to any one or more of the criteria, in respect of one or more properties of the other entity (or an entity with which the other entity does not deal at arm's length), identified in any of clauses (b)(iii)(A) to (D) of the definition; and
- under paragraph (c) of the definition, any property the fair market value of which is derived in whole or in part, directly or indirectly, from a particular share, indebtedness or right described in paragraph (a) or (b) of the definition.

New subsection 94(14) may apply in some circumstances to suspend a property's characterization as restricted property. For more details, see the commentary on that provision.

### **“specified charity”**

The expression “specified charity” is used in the definitions “arm's length transfer” and “resident beneficiary” in new subsection 94(1). An arm's length transfer includes a refund, from a specified charity in respect of a trust to the trust, of a gift previously made by the trust to the charity. A resident beneficiary under a trust does not include a specified charity. For more information, see the commentary on those definitions.

A specified charity in respect of a trust at any particular time means a person (in this commentary referred to as a “charity”) that at that time is

described in any of paragraphs (a) to (e) and (g.1) of the definition “total charitable gifts” in subsection 118.1(1). However, a specified charity does not include:

- a charity that does not, at a particular time, deal at arm's length with a “specified entity” in respect of the trust; or
- a charity that did not, at any “specified prior time” in respect of the charity, deal at arm's length with a specified entity in respect of the trust.

For this purpose, a “specified prior time” in respect of a charity is defined in paragraph (c) of the definition “specified charity” as meaning any time, before the particular time, at which

- an amount was payable to the charity as a beneficiary under the trust,
- an amount was received by the charity on the disposition of the charity's interest in the trust, or
- a benefit was received or enjoyed by the charity from or under the trust.

Paragraph (d) of the definition “specified charity” defines a “specified entity” in respect of a trust at any time to mean

- an entity that is at that time beneficially interested in the trust, a contributor to the trust, a person related to a contributor to the trust, a trustee of the trust, an entity that could reasonably be considered to have influence over the operation of the trust or the enforcement of its terms, or an entity that could reasonably be considered to have influence over the selection or appointment of an entity referred to above, or
- any group at least one of the members of which is described immediately above.

### **“specified contributor”**

The expression “specified contributor” is used in paragraph 94(2)(r) and paragraph (h) of the definition “exempt foreign trust” in new subsection 94(1).

Paragraph (*h*) of the definition “exempt foreign trust” is intended to ensure that investors in commercial investment trusts are subject to the regime for foreign investment entities in new sections 94.1 to 94.4 of the Act. Where an investor in such a commercial investment trust sells or has redeemed a beneficial interest in the trust, paragraph 94(2)(*r*) may apply to ensure that the acquisition of that interest will, after the sale or redemption, not be treated as a contribution to the trust.

For taxation years in respect of which new section 94 applies to a trust, the definition is relevant in applying both paragraph 94(2)(*r*) and the definition “exempt foreign trust”. For earlier taxation years, the definition “specified contributor” will generally only be relevant in determining whether an investor in the trust has ceased to be a contributor to the trust because of paragraph 94(2)(*r*).

An entity can only qualify as a specified contributor to a trust at any time if, at that time, it is both a beneficiary under, and a contributor to, the trust.

If this condition is met and that time is both before February 17, 1999 and immediately before a sale or redemption of the entity’s interest as a beneficiary under the trust, then the entity will be a specified contributor in respect of that interest for the purpose of applying paragraph 94(2)(*r*) to that sale or redemption. If paragraph 94(2)(*r*) applies, then in applying section 94 to the entity after the sale or redemption, the entity is treated as not having made any contribution to the trust in respect of its acquisition of that interest.

For a particular entity that is a beneficiary under a trust at a particular time that is after February 16, 1999, the particular entity will be a specified contributor to the trust at the particular time only if

- it is, at the particular time, a contributor to the trust;
- at all times that it is a beneficiary under the trust, its interest as a beneficiary is a “specified fixed interest” (as defined in subsection 94(1)) in the trust;
- it identifies, in a timely fashion, the trust in prescribed form or a copy of the terms of the trust that apply at the particular time have been filed, in a timely fashion, with the Minister by or on behalf of the trust; and

- where the particular entity is not an “exempt taxpayer” (as defined in subsection 94(1)), it is reasonable to conclude, in respect of any contribution made by it to the trust after February 16, 1999 and on before the particular time, that

(A) no consideration was received (other than property received by the particular entity that is the particular entity's interest as a beneficiary under the trust),

(B) none of the reasons (determined by reference to all the circumstances including the terms of the trust, an intention, the laws of a country or the existence of an agreement, a memorandum, a letter of wishes or any other arrangement) for the contribution is the acquisition at any time by any entity (other than the particular entity) of an interest as a beneficiary under the trust, and

(C) the fair market value of the particular contribution is equal to the fair market value, at the time of the particular contribution, of the particular entity's interest as a beneficiary under the trust acquired as a result of the particular contribution.

Where the particular entity qualifies at any time as a specified contributor, the sale or redemption, immediately after that time, of its interest as a beneficiary under the trust may result, as described above, in the application of paragraph 94(2)(r). In addition, if the particular entity is a resident contributor to a non-resident commercial investment trust, that was seeking to meet, at that time, the requirements of paragraph (h) of the definition “exempt foreign trust”, the particular entity's contributions to the trust would not alone cause the trust to fail to meet those requirements (ignoring subsection 94(16) of the Act).

Note, however, that an entity will not qualify as a specified contributor to a trust if at any time after February 16, 1999, the entity (or another entity with which it does not deal at arm's length) contributes restricted property to the trust. As a result, even if the contribution of restricted property were in consideration for the acquisition of an interest as a beneficiary under the trust, paragraph 94(2)(r) would not apply, to expunge the contribution, upon the sale or redemption of the interest in the trust. Moreover, the entity's status as a resident contributor to the trust may jeopardize the trust's ability to qualify as an exempt foreign trust.



### **“specified controlled foreign affiliate”**

A “specified controlled foreign affiliate” of a particular entity at any time means an entity that would, at that time, be a controlled foreign affiliate of the particular entity if the particular entity were resident in Canada at that time. The definition is used for the purpose of the definition “specified party”.

### **“specified fixed interest”**

The expression “specified fixed interest” is relevant in applying paragraph (b) of the definitions “exempt taxpayer” in subsections 94(1) and 94.1(1), paragraph (h) of the definition “exempt foreign trust” in subsection 94(1), and paragraphs 94(2)(q) and (r). These provisions are intended to apply only to commercial investment trusts.

A specified fixed interest at any time of an entity in a trust means a capital interest (as defined in subsection 108(1) of the Act) of the entity in the trust, if

- the interest includes, at that time, a right of the entity as a beneficiary under the trust to receive, at or after that time and directly from the trust, income or capital of the trust;
- the interest was issued by the trust;
- no right of the entity as a beneficiary under the trust to income or capital of the trust may cease, other than because of a specified transaction or event, to be a right of the entity; and
- the trust has never been a personal trust.

The specified transaction or event as a result of which a right of the entity to income or capital of the trust may cease to be the entity’s without jeopardizing the interest’s status as a specified fixed interest is one under which the entity (or the entity’s legal representatives) is entitled to receive an amount equal to the fair market value of the right immediately before the right ceased to be a right of the entity (or the entity’s legal representatives). These are intended to include a redemption or sale of the interest at any time, and a payment, in respect of the interest, described in paragraph (h) or (i) of the definition “disposition” in subsection 248(1). Further, the ability of the entity to make a gift of that interest will not cause the interest to lose its status as a specified fixed interest.

### **“specified party”**

New subsection 94(8) of the Act provides a rule for calculating an entity's recovery limit for the purpose of determining under subsection 94(7) of the Act the extent of an entity's limitation on liability arising under a provision referred to in new paragraph 94(3)(d). A “specified party” in respect of a particular entity at any time means an entity that is at that time:

- under paragraph (a) of the definition, an individual who is a spouse or common-law partner of the particular entity;
- under paragraph (b) of the definition, a “specified controlled foreign affiliate” (as described in the commentary immediately above) of the particular entity, or of a spouse or common-law partner of the particular entity;
- under paragraph (c) of the definition, an entity for which it is reasonable to conclude that the benefit referred to in subparagraph 94(8)(a)(iii) of the Act (i.e., a benefit received or enjoyed under a trust) was conferred either
  - (i) in contemplation of the entity becoming after that time a “specified controlled foreign affiliate” of an entity referred to in subparagraph (b)(i) or (ii) of the definition, or
  - (ii) to avoid or minimize a liability under this Part that arose, or that would otherwise have arisen, because of the application of subsection (3) with respect to the particular entity; or
- under paragraph (d) of the definition, a corporation in which the particular entity is a shareholder, if the corporation is or was beneficially interested in a trust, and the particular entity is a beneficiary under the trust solely because of the application of paragraph (b) of the definition “beneficiary” in subsection 94(1) to the particular entity in respect of the corporation.

### **“specified property”**

New subsection 94(9) of the Act can affect the calculation of the amount of a “contribution” (as defined in new subsection 94(1)) to a trust of “specified property”. For this purpose, “specified property” means:

- a share of the capital stock of a corporation, an interest as a beneficiary under a trust, an interest in a partnership, or an interest in any other entity;
- a right to acquire any of the above; or
- any other property deriving its value primarily from property described above.

### **“specified share”**

A specified share means a share of the capital stock of a corporation other than a share that is prescribed for the purpose of paragraph 110(1)(d). This expression is relevant to the definition “restricted property” in subsection 94(1). For more information, see the commentary on the definition “restricted property”.

### **“specified time”**

A specified time, in respect of a trust for a taxation year of the trust, means

- if the trust exists at the end of the taxation year, the time that is the end of that taxation year; and
- if the trust ceases to exist after **Announcement Date**, the time, in that taxation year that is immediately before the time at which the trust ceases to exist.

This expression is relevant in determining whether paragraph 94(3)(a) applies to deem the trust to be resident in Canada, for the taxation year, for a number of purposes. It also applies in respect of subsections 94(7) and (10). For more detail, see the commentary on those provisions.

### **“testamentary beneficiary”**

The expression “testamentary beneficiary” is used in the definition “resident beneficiary” in new subsection 94(1). A resident beneficiary under a trust does not include a testamentary beneficiary.

A testamentary beneficiary in respect of a trust at a particular time means an entity that is a beneficiary under the trust solely because of a right of the beneficiary to receive or otherwise obtain the use of any of the trust’s income or capital, only on or after the death after that time of

a specified individual. For this purpose a specified individual is an individual who is, at that time, alive and a contributor to the trust, an individual related to a contributor to the trust or an individual who would have been related to a contributor to the trust if every individual who was alive before that time were alive at that time.

### **“trust”**

A definition “trust” is provided for the purpose of applying section 94. The definition clarifies that a reference to a trust in that section includes an estate.

## **Rules of Application**

ITA

94(2)

New subsection 94(2) of the Act sets out a number of rules for use in applying section 94. These rules are primarily relevant for the purposes of determining whether a transaction constitutes a “contribution” (as defined in subsection 94(1)) of property to a trust. These rules are also relevant for the purposes of subsections 94(7) to (9) and the amended reporting rules in subsections 162(10.1) and 163(2.4) and section 233.2.

Paragraphs 94(2)(a) to (m) include rules that deem certain loans or transfers, the granting of options and the provision of services to be transfers of property to an entity. A deemed transfer will be considered to be a contribution to a trust if the transfer falls within the criteria of the definition “contribution” in subsection 94(1). In this regard, it should be noted that a transfer or loan, unless it is deemed to be a contribution under any of paragraphs 94(2)(n) to (q), will not be considered a contribution if it is an “arm's length transfer” (as defined in new subsection 94(1)). In addition, paragraphs 94(2)(r) to (u), may apply to deem certain transfers not to be contributions.

The rules in subsection 94(2) generally apply to taxation years of trusts that begin after 2002, but in some cases relief is provided with regard to transactions or events that occur before June 23, 2000 or October 11, 2002. In addition, trusts created in 2001 and trusts created in 2002 may elect in writing (by filing the election with the Minister of National Revenue on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2001 and 2002, as the case may be.



### *Deemed transfers*

Paragraph 94(2)(a) of the Act generally applies to indirect loans or transfers of property to a trust through transfers to other entities.

Paragraph (a) deems a transfer of property (other than an “arm's length transfer”, as defined in new subsection 94(1) or a transfer to which paragraph 94(2)(c) applies) to be a direct transfer to a trust if the property is transferred from one entity to another and, as a result of the transfer, the fair market value of the property of the trust increases or the liabilities of the trust decrease. Where paragraph (a) applies, paragraph 94(2)(b) deems the fair market value of property deemed transferred under paragraph 94(2)(a) to be the total of all amounts each of which is the absolute value of an increase in the fair market value of the trust property or a decrease in the liabilities of the trust because of the transfer.

Paragraph 94(2)(c) also applies to indirect loans or transfers of property to a trust. Paragraph (c) deems a transfer or loan of property (other than an “arm's length transfer”) from an entity to another entity to be a direct transfer to a trust where the trust holds property the fair market value of which is derived from property held by the other entity. Paragraph 94(2)(d) deems the fair market value of property deemed transferred under paragraph 94(2)(c) to be the fair market value of the property actually transferred.

Paragraph 94(2)(e) deems a particular entity that provides a guarantee or other financial assistance to another entity to have transferred property to that other entity. Any property given to the particular entity by the other entity in exchange for the guarantee or other financial assistance is deemed to have been transferred to the particular entity in exchange for the property deemed by subparagraph (e)(i) to have been transferred. Under subparagraph 94(2)(h), the fair market value of the property deemed by subparagraph (e)(i) to have been transferred is deemed to be the fair market value of the assistance.

Paragraph 94(2)(f) applies where any service (other than an exempt service, as defined in subsection 94(1)) is rendered after June 22, 2000 by an entity to, for or on behalf of another entity. In these circumstances, the entity rendering the service is deemed to have transferred property to the other entity. Any property given to the particular entity by the other entity in exchange for the service is deemed to have been transferred to the particular entity in exchange for the property deemed by subparagraph (f)(i) to have been transferred. For

more information on the definition “exempt service”, see the commentary on that definition.

Under paragraph 94(2)(h), the fair market value of the property deemed under subparagraph 94(2)(f)(i) to have been transferred is deemed to be equal to the fair market value of the services rendered.

For greater certainty, paragraph 94(2)(g) provides that a corporation is considered to transfer shares that it issues. Similar rules, also contained in paragraph 94(2)(g), apply to interests in a trust issued by the trust, interests in a partnership issued by the partnership or interest in an other entity issued by the entity, as well as to debt issued to an entity by another entity and a right (granted after June 22, 2000 by the entity from which the right was acquired) to acquire or to be loaned property.

As noted above, paragraph 94(2)(h) is relevant to determining the fair market value of property deemed under subparagraphs 94(2)(e)(i) and (f)(i) to have been transferred.

Paragraph 94(2)(i) deems an entity to have become obligated at a particular time to transfer property to another entity where the entity becomes obligated to do an act (*e.g.*, the rendering of a service) that would constitute the transfer of a property to another entity if the act were to occur. This rule is generally relevant for the purposes of paragraph (c) of the definition “contribution” in subsection 94(1).

Paragraph 94(2)(j) applies, for the purpose of applying at any time the definition “non-resident time” in subsection (1), if a trust acquires property of an individual as a consequence of the death of the individual. In these circumstances, paragraph 94(2)(j) deems the individual to have transferred the property to the trust immediately before the individual's death.

Paragraph 94(2)(k) applies where a particular entity loans or transfers property to another entity at the direction of or with the acquiescence of a second entity (the “specified entity”). In these circumstances, if it is reasonable to conclude that one of the reasons for the transfer is to avoid or minimize a liability of any entity under Part I of the Act that arose, or that would otherwise have arisen, because of the application of subsection (3), the transfer is deemed to be a transfer made jointly by the particular entity and the specified entity.

Paragraph 94(2)(l) also applies where a particular entity loans or transfers property to another entity at the direction of or with the

acquiescence of a specified entity. In these circumstances, the transfer is deemed to be a transfer made jointly by the particular entity and the specified entity if

- the transfer is made at a time that is not, or would not be, if the transfer or loan were a contribution of the specified entity, a “non-resident time” (as defined in new subsection 94(1)) of the specified entity, and
- either
  - the particular entity is at the time of the transfer a controlled foreign affiliate of the specified entity (or would be a controlled foreign affiliate of the specified entity if the specified entity were resident in Canada), or
  - it is reasonable to conclude that the transfer was made in contemplation of the particular entity becoming after the time of the transfer a controlled foreign affiliate of the specified entity (or a controlled foreign affiliate of the specified entity if the specified entity were resident in Canada).

The expression “controlled foreign affiliate” is defined in subsection 248(1) of the Act as having the meaning given in subsection 95(1).

Paragraph 94(2)(m) deems a particular entity to have transferred, at a particular time, a particular property or particular part of it, as the case may be, to a second entity if

- the particular property is a share of the capital stock of a corporation held at the particular time by the particular entity, and as consideration for the disposition at or before the particular time of the share, the particular entity received at the particular time (or became entitled at the particular time to receive) from the corporation a share of the capital stock of the corporation, or
- the particular property (or property for which the particular property is substituted property) was acquired, before the particular time, from the second entity by any entity, in circumstances that are described by any of subparagraphs 94(g)(i) to (vi) (generally, the issuance by the second entity of a financial instrument) and at the particular time,
  - the terms or conditions of the particular property change,

- the second entity redeems, acquires or cancels the particular property or the particular part of it,
- where the particular property is a debt owing by the second entity, the debt or the particular part of it is settled or cancelled, or
- where the particular property is a right to acquire or to be loaned property, the particular entity exercises the right.

### *Deemed contributions*

Paragraph 94(2)(n) applies where a particular trust makes a contribution to another trust. If this is the case, the contribution is deemed to have been made jointly by the particular trust and each other entity that is a contributor to the particular trust.

Paragraph 94(2)(o) applies where a partnership makes a contribution to a trust. Where this is the case, the contribution is deemed to have been made jointly by the partnership and by each entity that is a partnership member (other than a limited partner) at the time of the contribution. However, if a partnership has contributed to a trust, a limited partner of the partnership may also be considered to have made a contribution to the trust in respect of a transfer or loan made by the limited partner or another entity if any of the rules in subsection 94(2) so provide.

Paragraph 94(2)(p) provides, subject to paragraph 94(2)(o) and subsection 94(9), that the amount of a contribution to a trust at the time it was made is deemed to be the fair market value at that time of the property that was the subject of the contribution. The rule is useful for the purposes of new paragraph 94(2)(u), subsections 94(7) and (8), as well as the reporting penalty provisions in amended subsections 162(10.1) and 163(2.4). The rule is relevant because a contribution is defined by reference to a loan or transfer, rather than by reference to the property that was the subject of the transfer or loan.

Paragraphs 94(2)(q) and (r) apply to dealings in a “specified fixed interest” (as defined in new subsection 94(1)) in a trust and in a right, issued by the trust, to acquire such an interest. The rules for specified fixed interests apply in respect of commercial investment trusts. For more detail, see the commentary on the definitions “specified fixed interest” and “specified contributor” in subsection 94(1) and on paragraph (h) of the definition “exempt foreign trust” in subsection 94(1).



Paragraph 94(2)(q) deems an entity, that at any time acquires a specified fixed interest in a trust (or a right, issued by the trust, to acquire such an interest) from another entity (other than the trust), to have made a contribution to the trust at that time. The amount of the contribution is deemed to be the fair market value at that time of the specified fixed interest.

### *Transfers deemed not to be contributions*

Paragraph 94(2)(r) generally applies where a particular entity has made a contribution (e.g., because of paragraph 94(2)(q)) to a trust because of acquiring a specified fixed interest in the trust or a right to acquire such an interest, or has acquired a specified fixed interest in a trust as a consequence of making a contribution to the trust, and at a later time the interest or right, as the case may be, is transferred, for arm's length consideration, to another entity (i.e., upon a sale of the interest or right, or if the other entity is the trust that issued the interest or right, upon a redemption of the interest or right). In these circumstances, the particular entity is deemed, for the purpose of applying section 94 at any time after the later time, not to have made the contribution in respect of the specified fixed interest, or right, that is the subject of the sale if immediately before the later time (i.e., the time of the sale or redemption) the particular entity is specified contributor to the trust.

Paragraph 94(2)(s), in very general terms, provides that a transfer of property to a trust by a particular entity that is a manager or promoter of the trust, in exchange for an interest as a beneficiary under the trust, will not be considered a contribution of the particular entity to the trust while the beneficial interest is acquired and held by the particular entity because of a requirement imposed under securities laws. Paragraph 94(2)(s) will be relevant in the relatively rare circumstance that a commercial investment trust cannot rely on the exemption for exempt foreign trusts in order to avoid the application of subsection 94(3). Paragraph 94(2)(s) will apply in determining under that subsection whether the trust has a resident contributor or connected contributor (i.e., and hence, a resident beneficiary).

More specifically, under paragraph 94(2)(s), a transfer to a trust by a particular entity is deemed not to be, at a particular time, a contribution to the trust if

- the particular entity has transferred, at or before the particular time and in the ordinary course of business of the particular entity, property to the trust,

- the transfer is not an arm's length transfer, but would be an arm's length transfer if the definition "arm's length transfer" in subsection 94(1) were read without reference to paragraph (a), and subparagraphs (b)(i) to (iii) and (v) to (viii), of that definition,
- it is reasonable to conclude that the particular entity was the only entity that acquired, in respect of the transfer, an interest as a beneficiary under the trust,
- the particular entity was required, under the securities law of a country or of a political subdivision of the country in respect of the issuance of beneficial interests by the trust, to acquire the interest because of the particular entity's status at the time of the transfer as a manager or promoter (as defined in subsection 94(1)) of the trust,
- at the particular time the trust is not an exempt foreign trust, but would be at that time an exempt foreign trust if it had not made an election under paragraph (h) of the definition "exempt foreign trust", and
- the particular time is before the earliest of
  - the first time at which the trust becomes an exempt foreign trust,
  - the first time at which the particular entity ceases to be a manager or promoter of the trust, and
  - the time that is 24 months after the first time at which the total fair market value of consideration received by the trust in exchange for beneficial interests (other than the particular entity's interest referred to in subparagraph 94(2)(s)(iii)) in the trust is greater than \$500,000.

Paragraph 94(2)(t) generally expunges a contribution of shares or indebtedness of a Canadian corporation from the corporation to a trust if the corporation issued (in circumstances described in subparagraph 94(2)(g)(i) or (v)) the shares or the debt to the trust (or to another entity in circumstances that resulted in the Canadian corporation being deemed by paragraph 94(2)(c) to have transferred particular property to the trust) and the trust or another entity later sells the shares or indebtedness in circumstances in which the parties to the sale deal with each other on an arm's length basis.

However, the application of 94(2)(t) will not effect the application of 94(2)(c) or (g) in respect of the original transfer by the corporation to the trust or the other entity: such transfers will continue to be treated as transfers under section 94. In addition, the application of 94(2)(t) will not expunge the status as a contribution to the trust of a transfer made by an entity and involving the corporation (e.g., an entity that transferred property to the corporation, and hence the trust, because of the application of paragraph 94(2)(c) and (m)).

More specifically, a transfer, by a Canadian corporation of particular property (i.e., a share or debt), that is at a particular time a contribution by the Canadian corporation to a trust, is deemed not to be, after the particular time, a contribution by the Canadian corporation to the trust if

- either the trust acquired the particular property before the particular time from the Canadian corporation in circumstances described in subparagraph 94(2)(g)(i) or (v), or another entity acquired property before the particular time from the Canadian corporation in circumstances described in subparagraph 94(2)(g)(i) or (v) and because of that acquisition the Canadian corporation was deemed by paragraph 94(2)(c) to have transferred the particular property to the trust;
- as a result of a transfer (i.e., a sale of, or a redemption by the Canadian corporation of, the issued shares or debt) at the particular time by any entity (referred to in this paragraph as the “seller”) to another entity (referred to in this paragraph as the “purchaser”) the trust ceases to hold property that is shares of the capital stock of, or debt issued by, the Canadian corporation or the trust ceases to hold property that is property the fair market value of which is derived in whole or in part, directly or indirectly, from shares of the capital stock of, or debt issued by, the Canadian corporation;
- the purchaser deals at arm’s length immediately before the particular time with the Canadian corporation, the trust and the seller;
- in exchange for the sale, the purchaser transfers or becomes obligated to transfer property (which property is referred to in this paragraph as the “consideration”), to the seller; and

- it is reasonable to conclude
  - having regard only to the sale and the consideration that the seller would have been willing to make the sale if the seller dealt at arm's length with the purchaser,
  - that the terms and conditions made or imposed in respect of the exchange are terms and conditions that would have been acceptable to the seller if the seller dealt at arm's length with the purchaser, and
  - that the value of the consideration is not, at or after the particular time, determined in whole or in part, directly or indirectly, by reference to shares of the capital stock of, or debt issued by, the Canadian corporation.

Paragraph 94(2)(u) applies to a transfer, before October 11, 2002, to a personal trust by an individual (other than a trust) of particular property. Where the conditions in subparagraphs 94(2)(u)(i) and (ii) are met, the transfer of the particular property is deemed not to be a contribution of the particular property by the individual to the trust. Paragraph 94(2)(u) is intended to provide relief to individuals that have transferred a relatively small amount of property to a trust (e.g., the initial settlement of a coin on the trust) where the individual can reasonably be considered not to have been involved with the use of the trust as part of what is commonly referred to as an estate freeze (i.e., see the condition in clause 94(2)(u)(ii)(A) that the trust never have acquired from the individual restricted property).

The conditions in subparagraphs 94(2)(u)(i) and (ii) are that

- the individual identifies the trust in prescribed form filed with the Minister on or before the individual's filing-due date for the individual's 2003 taxation year (or a later date that is acceptable to the Minister), and
- the Minister is satisfied that
  - (A) the individual (and any entity not dealing at any time at arm's length with the individual) has never loaned or transferred, directly or indirectly, restricted property to the trust,



(B) in respect of each contribution (determined without reference to paragraph 94(2)(u)) made before October 11, 2002 by the individual to the trust, none of the reasons (determined by reference to all the circumstances including the terms of the trust, an intention, the laws of a country or the existence of an agreement, a memorandum, a letter of wishes or any other arrangement) for the contribution was to permit or facilitate, directly or indirectly, the conferral at any time of a benefit (for greater certainty, including an interest as a beneficiary under the trust) on

(I) the individual,

(II) a descendant of the individual, or

(III) any entity with whom the individual or descendant does not, at any time, deal at arm's length, and

(C) the total of all amounts each of which is the amount of a contribution (determined without reference to paragraph 94(2)(u)) made before October 11, 2002 by the individual to the trust does not exceed the greater of

(I) 1% of the total of all amounts each of which is the amount of a contribution (determined without reference to paragraph 94(2)(u)) made to the trust before October 11, 2002, and

(II) \$500.

The examples below illustrate the operation of subsection 94(2) and the definition “contribution” in subsection 94(1).

### ***Example 1***

*Donald is a long-term resident of Canada. In 2003, Donald pays higher than fair market value consideration for a property acquired from a corporation. A non-resident trust holds shares in the corporation. The fair market value of those shares increases because of the transaction.*

## *Results*

1. Under paragraph 94(2)(a), Donald is considered to have transferred property to the trust in these circumstances. The exception for arm's length transfers does not apply.
2. As a consequence, Donald is considered to have made a contribution to the trust, which results in Donald being a contributor and a resident contributor to the trust.

## *Example 2*

1. Lucie, a long-term resident of Canada, transfers property to Canco on condition that Canco direct Canco's wholly-owned foreign subsidiary (Foreignco-1) to transfer properties to another corporation (Foreignco-2) for consideration that is less than fair market value.
2. Shares of the capital stock of Foreignco-2 are held by a non-resident trust.
3. The fair market value of the Foreignco-2 shares increases as a result of the increase in the fair market value of the property owned by Foreignco-2.

## *Results*

1. The transfers to Canco and to Foreignco-2 are part of the same series of transactions.
2. Because of paragraph 94(2)(a), the transfer to Foreignco-2 is considered to be a transfer by Foreignco-1 to the trust. Because of paragraph 94(2)(l), the transfer by Foreignco-1 to the trust is considered to be jointly made by Foreignco-1 and Canco. (This would also be the result under paragraph 94(2)(k), if it was intended to avoid or minimize a liability under Part I.) The exception for arm's length transfers does not apply.
3. Canco is considered to have made a contribution to the non-resident trust because of paragraph (a) of the definition "contribution" in new subsection 94(1). Lucie is considered to have made a contribution to the trust under paragraph (b) of that definition. Both Lucie and Canco are therefore contributors and resident contributors to the trust.

*4. Foreignco-1 is also a “contributor” to the trust, but this does not have any practical consequences because Foreignco-1 is non-resident.*

## **Liabilities of Non-resident Trusts and Others**

ITA  
94(3)

New subsection 94(3) of the Act applies to a non-resident trust (other than an “exempt foreign trust”, as defined in subsection 94(1)) for a taxation year where, at a “specified time” in respect of the trust for the taxation year (generally, the end of the taxation year), there is a “resident contributor” to the trust or a “resident beneficiary” under the trust. All of these expressions are explained in detail in the commentary on new subsection 94(1).

Where subsection 94(3) applies to a non-resident trust for a taxation year, the trust is deemed to be resident in Canada throughout the year for the purposes specified in paragraph 94(3)(a). Except to the extent otherwise provided by subsection 94(4), a trust is deemed to be resident in Canada for a taxation year under subsection 94(3):

- for the purposes of applying sections 2, computing the trust's income for the year and computing the trust's liability for tax under Part I – with the result that the trust is subject to tax under that Part on its world-wide income for the year (including, for example, its income determined as a result of deemed dispositions under subsections 104(4) to (5.2) or 128.1(4));
- for the purpose of applying clause 53(2)(h)(i.1)(B) – with the result that the adjusted cost base to a beneficiary of the beneficiary's interest in a trust to which this clause applies is computed in the same way as for interests in trusts resident in Canada;
- for the purpose of applying the definition “non-resident entity” in subsection 94.1(1) – with the result that a beneficiary's interest in the trust is not treated as an interest of a beneficiary in a foreign investment entity for the purposes of new sections 94.1 and 94.2;

- for the purposes of applying subsections 104(13.1) to (29), 107(2.1), (2.002) and (5) and section 115 – with the result that the tax treatment of beneficiaries under the trust generally accords with the tax treatment available to beneficiaries under trusts that are resident in Canada;
- for the purposes of determining the obligation of the trust to file a return under sections 233.3 and 233.4 – with the result that the trust is required to file information returns under sections 233.3 (information return on foreign property holdings the total cost of which exceeds \$100,000) and 233.4 (information return on foreign affiliates);
- for the purpose of determining the liability of the trust for tax under Part XIII – with the result that the trust is exempt from Part XIII tax on amounts paid or credited to it;
- for the purpose of determining the liability of a non-resident person for tax under Part XIII on amounts paid or credited by the trust to the non-resident person (other than amounts referred to in paragraph 104(7.01)(b) in respect of the trust for the taxation year that are paid or credited to the non-resident person); and
- for the purpose of determining the rights and obligations of the trust under sections 150 to 180 – with the result that various administrative provisions in the Act apply in the same way as to other trusts resident in Canada. (These provisions include those with regard to the filing of returns, assessments, tax payments, arrears interest, refund interest, instalment interest, penalties, refunds and appeals.)

A trust to which subsection 94(3) applies is deemed to be resident in Canada throughout the year for the above purposes, including the computation of its income and its taxable income and section 2 of the Act. Section 2 of the Act imposes on every person resident in Canada at any time in a taxation year an obligation to pay an income tax on that person's taxable income for the year.

Under paragraph 1 of the resident article in Canada's income tax treaties, a reference in such a treaty to a "resident of a Contracting State" means any person who, under the law of that State, is liable to taxation in that State by reason of the person's domicile, residence, place of management or any other criterion of a similar nature. A person, in this context, would generally include a trust because of the



definition “person” in Canada’s income tax treaties. Because a trust to which subsection 94(3) applies is deemed to be resident of Canada and is liable to tax in Canada on its worldwide income, it will be considered a resident of Canada under paragraph 1 of the resident article in Canada's income tax treaties, whether it is also considered to be resident, under the applicable treaty, in another country or not.

A trust that is also resident of the other contracting state under a particular treaty would be a dual resident under the treaty. In the event of dual residency under an income tax treaty, the tie-breaker rules in the resident article applicable to individuals would not apply. The Canada Customs and Revenue Agency has expressed the view that in this context, the term “individual” is to be interpreted to mean natural person and not a trust. The Agency has indicated that this interpretation would generally prevail across most if not all of Canada's income tax treaties if the definition “person” in the particular treaty under consideration makes reference to both an “individual” and a “trust”. Even if a trust were considered an individual for the purpose of an income tax treaty, it is clear from the context of the tie-breaker rule applicable to individuals that it is intended to apply only to natural persons. This is because expressions such as “personal home”, “centre of vital interest” and “habitual abode” used in the tie-breaker rules have meaning only in reference to natural persons and would not be of use in clarifying the residence of a trust for the purpose of a treaty.

In general, therefore, under the income tax treaty the competent authorities of each contracting state would have to enter into an agreement to determine in which state the trust would be resident for the purpose of the particular treaty. In the absence of such an agreement Canada would exercise its first right to tax. Canada would grant foreign tax credits for the other State's income taxes paid by the trust.

In this regard, paragraph 94(3)(b) applies for the purposes of applying subsections 20(11) and (12) and section 126 in respect of the trust. Paragraph 94(3)(b) allows a trust to elect for the special rules in that paragraph to apply in determining the trust’s eligibility for a foreign tax credit. If the trust elects for a taxation year,

- the trust's income for the taxation year (other than the portion of the income that is from sources inside Canada or that is from a source, outside Canada, that is a business carried on by the trust outside Canada) is deemed, for the purposes of subsections 20(11) and (12) and section 126,

- to be income of the trust from sources (other than a business carried on by the trust) in a particular country (other than Canada) in which the trust is resident (determined without reference to this subsection), and
- not to be from any other source; and
- in determining the income or profits tax paid by the trust for the taxation year to the government of the particular country the trust can pool the total of all amounts each of which is the amount of an income or profits tax that was paid by the trust for the particular taxation year to the government of a country (other than Canada) and that can reasonably be regarded as a tax paid on the trust's income for the taxation year (other than the portion of the income that is from sources inside Canada or that is from a source, outside Canada, that is a business carried on by the trust outside Canada).

Paragraph 94(3)(b) also provides that in determining the non-business income tax (as defined by subsection 126(7)) paid by the trust for a taxation year to the government of a country other than Canada no amount shall be included to the extent that it can reasonably be regarded as attributable to income from a source in Canada.

Paragraph 94(3)(c) provides that a non-resident trust that becomes subject to subsection 94(3) for a particular taxation year, after not being subject to either new subsection 94(3) or existing paragraph 94(1)(c) for the preceding year is deemed, immediately before the end of the preceding taxation year, to have disposed of each property (other than property described in any of subparagraphs 128.1(1)(b)(i) to (iv)) held by the trust at that time for proceeds of disposition equal to its fair market value at that time. The trust is also deemed to have, at the beginning of the particular taxation year, acquired each of those properties so disposed of at a cost equal to its proceeds of disposition

Note, in this regard, that where paragraph 94(3)(c) applies to the trust in the particular taxation year to cause a disposition of trust property in the preceding taxation year, new paragraph 128.1(1.1)(b) provides that paragraph 128.1(1)(b) will not apply in the preceding taxation year.

Paragraphs 94(3)(c) and 128.1(1.1)(b) together are intended to ensure – in a manner similar to that for taxpayers that migrate to Canada – that certain gains or losses that accrued on certain property of the trust while the trust was non-resident are not subject to taxation in Canada.

Paragraph 94(3)(c) also complements the rule in subsection 94(6), which applies where a non-resident trust ceases to be an “exempt foreign trust” (as defined in subsection 94(1)). In this case, subsection 94(6) establishes the beginning of a new “stub” taxation year. If subsection 94(3) applies for that “stub” year, paragraph 94(3)(c) would be applicable with regard to the properties held by the trust at the beginning of that “stub” year.

### ***Example 1***

*A trust is created in 2003. The trust is not at any time an exempt foreign trust. At the end of its 2003 taxation year, the trust is non-resident and there are no resident contributors to the trust and no resident beneficiaries under the trust.*

*On February 1, 2004, John makes a contribution to the trust. At the end of the trust’s 2004 taxation year, John is a resident contributor to the trust, and the trust is non-resident.*

*On July 1, 2005 the sole trustee of the trust moves to Canada, becomes resident in Canada at that time and remains resident in Canada throughout the remainder of the year. Immediately before the trustee became resident in Canada, the trustee was non-resident and John remained a resident contributor to the trust.*

### ***Results***

#### ***Trust’s 2003 Taxation Year***

*1. Subsection 94(3) does not apply to deem the trust to be resident in Canada in computing its income for its 2003 taxation year.*

#### ***Trust’s 2004 Taxation Year***

*2. Paragraph 94(3)(a) applies to deem the trust to be resident in Canada, throughout its 2004 taxation year, for a number of purposes, including computing of its income. Because the trust was non-resident throughout its 2003 taxation year, paragraph 94(3)(c) also applies to deem the trust to have disposed of its property (other than certain properties described in subparagraphs 128.1(1)(b)(i) to (iv)) for fair market value proceeds immediately before the end of its last 2003 taxation year and to have reacquired those properties at a cost equal to that fair market value at the beginning of the 2004 taxation year. A related rule in paragraph 128.1(1.1)(b) suspends the application of the deemed disposition and re-acquisition rules in paragraph 128.1(1)(b) that would otherwise apply in that last 2003 taxation year because of*

*the trust becoming resident in Canada at the beginning of the 2004 taxation year.*

### *Trust's 2005 Taxation Year*

*3. Because the trustee of the trust becomes resident in Canada on July 1, 2005, paragraph 128.1(1)(a) will apply to deem the trust to have a taxation year-end immediately before the change of residency. At the end of this first 2005 taxation year of the trust, paragraph 94(3)(a) applies to deem the trust to be resident in Canada, throughout that first 2005 taxation year, for a number of purposes, including the computing of its income. However, paragraph 94(3)(c) will not apply because the trust was resident in Canada (i.e. because of the application of paragraph 94(3)(a) to the trust's 2004 taxation year) throughout the year preceding the 2005 taxation year.*

*4. Paragraph 128.1(1)(a) also applies to deem the trust to have a new taxation year at the time the trustee becomes resident in Canada on July 1, 2005. Because the trust is resident in Canada at the end of this second 2005 taxation year, paragraph 94(3)(a) does not apply to deem the trust to be resident in Canada in computing its income for that year.*

*5. As the trust is resident in Canada immediately after the end of its first 2005 taxation year (i.e., the 2005 taxation year discussed in #3 above), paragraph 128.1(1.1)(a) suspends the application of the deemed disposition and re-acquisition rules in paragraphs 128.1(1)(b) and (c) that would otherwise apply in respect of the end of that first 2005 taxation year because of the trust becoming resident in Canada on July 1, 2005. This ensures that the trust does not realize at that end of that first 2005 taxation year any accrued gains or losses of the trust solely because the basis of the trust's residency in Canada changes.*

*6. Note that where subsection 128.1(1.1) applies to a trust, it suspends only the application of paragraph 128.1(1)(b) (as a result paragraph 128.1(1)(c) also has no application) to the trust. If the trust becomes resident in Canada, it would continue to be subject to paragraph 128.1(1)(a). Also note that paragraph 94(4)(d) ensures that the application of paragraph 94(3)(a) to the trust will not affect the determination of the trust as having changed residence for the purposes of subsection 128.1(1).*

Paragraph 94(3)(d) imposes liabilities for a taxation year on entities who are "resident contributors" or "resident beneficiaries". Where subsection 94(3) applies to a trust for a taxation year, each of these entities is jointly and severally, or solidarily, liable with the trust in respect of the trust's obligations under sections 150 to 180. Typically, the most significant obligation in this context is the obligation to pay tax



instalments pursuant to section 156. However, the extent of the liability imposed by paragraph 94(3)(d) is limited by new subsection 94(7). For more information, see the commentary on subsections 94(7) to (9).

The expression “solidarily liable” is added to ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.

Paragraph 94(3)(e) imposes liabilities for a taxation year on each entity that is a beneficiary under the trust and was a person from whom an amount would be recoverable at the end of 2002 under subsection 94(2) (as it read in its application to taxation years that began before 2003) in respect of the trust if the entity had received before 2003 amounts described under paragraphs 94(2)(a) or (b) in respect of the trust (as those paragraphs read in their application to taxation years that began before 2003). Where subsection 94(3) applies to the trust for a taxation year, each of these entities is, to the extent of the entity's recovery limit for the year, jointly and severally, or solidarily, liable with the trust in respect of the trust's obligations under sections 150 to 180.

Note that subsection 94(3) generally does not result in the creation of any obligations for a trust that is subject to subsection 94(3) to withhold tax on distributions to non-resident beneficiaries under Part XIII or to pay any tax under Part XII.2. As noted above, one of the effects of subsection 94(3) is that the trust is not liable for such tax in connection with distributions of Canadian-source income to the non-resident beneficiaries in their capacities as beneficiaries.

Instead, the rules in new subsection 104(7.01) are designed so that there will be a reasonable level of Part I tax in respect of Canadian-source income received by the trust in the event the trust also distributes that income to non-resident beneficiaries in their capacity as beneficiaries. For more information, see the commentary on subsection 104(7.01).

However, in the event that the trust pays or credits an amount to a non-resident and that amount is not referred to in paragraph 104(7.01)(b) in respect of the trust for the taxation year, the non-resident will continue to be liable for any Part XIII tax on the amount.

## Excluded Provisions

ITA

94(4)

New subsection 94(4) of the Act provides that the rules in paragraph 94(3)(a) treating non-resident trusts as resident in Canada do not apply for certain limited purposes:

- the definitions “arm’s length transfer”, “exempt taxpayer” and “exempt foreign trust” in subsection 94(1) – thus ensuring that there is no circularity in applying those definitions due to fact that those definitions impose a requirement that a trust be non-resident;
- subsections 70(6) and 73(1) and paragraph 107.4(1)(c) (other than subparagraph 107.4(1)(c)(i)) and subparagraph (f)(ii) of the definition “disposition” in subsection 248(1) – thus ensuring that rules allowing in some cases for a rollover of property on transfers to a trust generally do not apply to transfers to a trust deemed to be resident in Canada by subsection 94(3);
- paragraph (a) of the definition “mutual fund trust” in subsection 132(6) – a reference that makes it clear that a trust deemed to be resident in Canada by subsection 94(3) will not be treated as a mutual fund trust for any purpose; and
- determining whether, in applying subsection 128.1(1), the trust becomes resident in Canada at a particular time and determining whether, in applying subsection 128.1(4), the trust ceases to be resident in Canada at a particular time – thus ensuring that the deeming of a trust to be resident under paragraph 94(3)(a) does not apply to affect a determination of whether a trust has changed residence at any time (e.g., upon a change of trustees or upon a change of residence of trustees).

Furthermore, except as otherwise permitted under subsection 216(4.1) of the Act, paragraph 94(3)(a) does not relieve a payer of Canadian-source income from the obligation to withhold amounts under section 215 in connection with amounts paid to a trust deemed to be resident in Canada by subsection 94(3). This is so even though such a trust is not liable for Part XIII tax on amounts paid or credited to it, because of the application of subparagraph 94(3)(a)(vii). The trust would be expected

to apply for a refund of such tax, which would be given except to the extent that there are any outstanding liabilities of the trust with regard to Part I tax.

## **Deemed Cessation of Residence**

### **ITA 94(5)**

New subsection 94(5) of the Act deems a trust to have ceased to be resident in Canada at the earliest time in a specified period at which there is neither a “resident contributor” to the trust nor a “resident beneficiary” under the trust. For this purpose, the specified period is the period that would (if the Act were read without reference to subsection 128.1(4)) be a taxation year of the trust

- that immediately follows a taxation year of the trust throughout which it was resident in Canada,
- at the beginning of which there was either a resident contributor to the trust or a resident beneficiary under the trust, and
- at the end of which the trust is non-resident.

For more information on the expressions “resident contributor” and “resident beneficiary”, as defined in new subsection 94(1), see the commentary on those provisions.

Where subsection 94(5) applies, the cessation of residence in Canada of a trust results in the application of subsection 128.1(4). Under that subsection, a taxation year of the trust is deemed to have ended immediately before the earliest time in the specified period described above. At that deemed taxation year-end, the criteria in subsection 94(3) are satisfied. Accordingly, the trust will be subject to tax under Part I on its worldwide income for that year because it is considered under subsection 94(3) to be resident in Canada throughout that year. Under new paragraph 94(3)(d), each “resident beneficiary” or “resident contributor” at the time of that deemed taxation year end can be jointly and severally, or solidarily, liable with the trust for the trust's income tax liabilities under the Act for that year. (For more detail on the expression “solidarily”, please refer to the introductory commentary above on new section 94.)

## **Becoming or Ceasing to be an Exempt Foreign Trust**

ITA

94(6)

New subsection 94(6) of the Act generally provides that, if a trust becomes or ceases to be an “exempt foreign trust” (as defined in new subsection 94(1)) at any time, the trust's taxation year is deemed to have ended immediately before that time, a new “stub” taxation year is deemed to have begun at that time and the trust is deemed not to have established a fiscal period before that time. However, subsection 94(6) does not apply where a trust ceases to be an exempt foreign trust because it becomes resident in Canada.

Subsection 94(3) may apply in respect of the later “stub” taxation year of the trust if the criteria set out in that subsection are satisfied at a “specified time” in respect of the trust for the taxation year (generally, the end of the taxation year). Where this is the case, the trust would be subject to tax under Part I on its world-wide income for that later “stub” year because it would be considered under subsection 94(3) to be resident in Canada for that year.

## **Limit to Amount Recoverable**

ITA

94(7) and (8)

New subsection 94(7) of the Act allows for a limitation of the amount that may be recovered from an entity that would otherwise be jointly, severally, or solidarily, liable for the entire amount of a trust's tax obligations under the Act. Subsection 94(7) applies to an entity (other than an entity that is deemed, by subsection 94(12) or (13), to be a contributor or a resident contributor to the trust) in respect of a particular taxation year of the trust where three conditions are satisfied.

The first condition is satisfied in respect of a particular taxation year of the trust:

- where, under subparagraph 94(7)(a)(i), the entity is jointly and severally, or solidarily, liable with the trust only because the entity was a “resident beneficiary” (as defined in new subsection 94(1)) under the trust at a specified time in respect of the trust for the particular year, or



- where, under subparagraph 94(7)(a)(ii), at a specified time in respect of the trust for, the total amount (determined with reference to paragraph 94(2)(b), (d), (h), (p) and (q) and subsection 94(9)) of contributions made to the trust by the entity (or by another entity not dealing at arm's length with the entity) is not more than the greater of \$10,000 and 10% of the total amount of all contributions to the trust.

The second condition, under paragraph 94(7)(b), requires that the entity have filed on a timely basis all information returns required to be filed by the entity in respect of the trust under section 233.2 (or on any later day that is acceptable to the Minister of National Revenue). However, the second condition need not be satisfied if the first condition is satisfied because the total determined under subparagraph 94(7)(a)(ii) (in respect of the entity and all entities not dealing at arm's length with it) is \$10,000 or less.

The third condition, under paragraph 94(7)(c), is satisfied in respect of an entity and a particular taxation year of the trust where it is reasonable to conclude that each transaction or event that occurred before the end of the particular year at the direction of, or with the acquiescence of, the entity satisfied the following conditions:

- none of the purposes of the transaction or event was to enable the entity to avoid or minimize any liability under a provision referred to in paragraph 94(3)(d) in respect of the trust, and
- the transaction or event was not part of a series of transactions or events any of the purposes of which was to enable the entity to avoid or minimize any liability under a provision referred to in paragraph 94(3)(d) in respect of the trust.

There are a number of transactions or events, or series of transactions or events, that may result in a failure to satisfy the third condition (e.g., an artificial dilution of an entity's relative contribution to the trust (i.e., below the 10% level); or corporate distributions that have the effect of avoiding or minimizing the impact of the three-year rule described in subsection 94(9)).

Reference should be made in this context to the definition "contribution" in subsection 94(1), as well as to related rules in subsection 94(2).

Where subsection 94(7) applies to an entity in respect of a taxation year of a trust, the amount recoverable at any time from the entity in respect of the year is limited to the person's "recovery limit", determined under subsection 94(8), in respect of the trust and the year.

Under subsection 94(8), the amount of the recovery limit that applies to a particular entity at any particular time is calculated as follows:

- ADD amounts received or receivable after 2000 and before the particular time by the particular entity on the disposition of all or part of the particular entity's interest as a beneficiary under the trust, or by another entity that was, at the time the amount became receivable, a specified party (as defined in subsection 94(1)) in respect of the particular entity on the disposition of all or part of the specified party's interest as a beneficiary under the trust;
- ADD an amount (other than an amount described in the paragraph above) made payable by the trust after 2000 and before the particular time to the particular entity because of the interest of the particular entity as a beneficiary under the trust, or another entity (that was, at the time the amount became payable, a specified party in respect of the particular entity) because of the interest of the specified party as a beneficiary under the trust;
- ADD the fair market value of benefits received or enjoyed, after 2000 and before the particular time, under the trust by the particular entity (or an entity that was, at the time the benefit was received or enjoyed, a specified party in respect of the particular entity), not otherwise taken into account above;
- ADD the maximum amount that would be recoverable from the particular entity at the end of 2002 under subsection 94(2) (as it read in its application to taxation years that began before 2003) if the trust had had tax payable under Part I of the Act at the end of 2002 in excess of the total of the amounts described in respect of the entity under paragraphs 94(2)(a) and (b) (as they read in their application to taxation years that began before 2003), except to the extent that the amount so recoverable is in respect of an amount that is included in the particular entity's recovery limit because of subparagraph 94(8)(a)(i) or (ii);
- ADD the total amount (determined with reference to paragraphs 94(2)(b), (d), (h), (p) and (q) and subsection 94(9)) of

contributions made to the trust by the particular entity, to the extent that this amount exceeds the total of the first four amounts;

- SUBTRACT previous recoveries by the Canada Customs and Revenue Agency (“CCRA”) under subsection 94(3) (or under subsection 94(1) as it read in its application to taxation years that began before 2003) from the particular entity in respect of the trust and the year or a preceding taxation year of the trust;
- SUBTRACT previous recoveries by the CCRA under subsection 94(3) (or under subsection 94(1) as it read in its application to taxation years that began before 2003) from a specified party in respect of the particular entity in respect of the trust and the year or a preceding taxation year of the trust; and
- SUBTRACT the amount, if any, by which the particular entity's tax payable under this Part for any taxation year in which an amount described in any of subparagraphs 94(8)(a)(i) to (iii) was paid, became payable, was received, became receivable or was enjoyed by the particular entity exceeds the amount that would have been the particular entity's tax payable under this Part for that taxation year if no such amount were paid, became payable, were received, became receivable or were enjoyed by the particular entity in that taxation year.

For more information on subsections 94(11) to (13), or the expression “specified party” as defined in subsection 94(1), see the commentary on those provisions.

### **Determination of contribution amount**

#### **ITA 94(9)**

Subsection 94(9) affects the calculation of the amount of a “contribution” (as defined in new subsection 94(1)) to a trust of “specified property” (as defined in new subsection 94(11)) for the purpose of determining whether the “recovery limit” limitation applies to a contributor to the trust and of determining the amount of that recovery limit.

The amount of a contribution to a trust because of a transfer to the trust of specified property is deemed by subsection 94(9) to be the greater of:

- the amount, otherwise determined, at that time of the contribution; and
- the amount that is the greatest fair market value of the specified property (or of substituted property) in the period that begins immediately after that time and ends at the end of the third calendar year after that time.

For more information on the expression “specified property” as defined in new subsection 94(1), see the commentary on that provision.

Subsection 94(9) allows for a reasonable opportunity for recovery of tax by the CCRA in the context of a transaction or series of transactions involving the transfer of specified property. Consider, for example, an estate freeze under which common shares in the capital stock of a corporation are transferred directly or indirectly to a non-resident trust. Because of the difficulties associated with valuing the common shares at the time of the transfer, it is appropriate to provide for a valuation as described above.

In conjunction with new subsection 94(9), subparagraph 152(4)(b)(vi) of the Act is amended to ensure that a reassessment of a taxpayer arising out of the application of subsection 94(9) can be undertaken by the CCRA within 3 years after the normal reassessment period of the taxpayer in respect of the taxpayer's relevant taxation year.

### **Where Contributor Becomes Resident in Canada Within 60 Months after Contributing**

#### **ITA 94(10)**

New subsection 94(10) of the Act applies to determine whether there is a “connected contributor” (as defined in new subsection 94(1)) to a trust for the purpose of applying the definition “resident beneficiary” (as defined in new subsection 94(1)). Under new paragraph 94(3)(d) of the Act, a resident beneficiary can, to an extent, be liable for the trust's income tax under Part I of the Act. For more information, see the commentary on those definitions and subsections 94(3) and (7) to (9).



A “contribution” (as defined in new subsection 94(1)) to a trust by a contributor is considered to have been made at a time other than a “non-resident time” (as defined in subsection 94(1)) if the contributor becomes resident in Canada at any time within the period (referred to in this commentary as the “60-month post period”) 60 months after the time of the contribution. However, to facilitate the administration of the definition “non-resident time”, paragraph (b) of the definition “connected contributor” and subsection 94(3), the definition “non-resident time” is drafted so that such a contributor and the trust may, subject to subsection 94(10), treat the time of the contribution as a non-resident time for the purposes of applying the definition “connected contributor” and subsection 94(3) at a “specified time” (as defined in new subsection 94(1)) in respect of the trust for any particular trust taxation year if at the specified time the contributor still has not become resident in Canada within the 60-month post period.

Subsection 94(10) deems (for the purpose of applying the definition “connected contributor” at each specified time, in respect of a trust for a taxation year of the trust, that is before the particular time at which the contributor becomes resident in Canada within the 60-month post period) the contribution to have been made at a time other than a “non-resident time” of the contributor if:

- in applying the definition “non-resident time” as of each of those specified times, the particular contribution was made at a non-resident time of the contributor; and
- in applying the definition “non-resident time” at the particular time, the contribution is made at a time other than a non-resident time of the contributor.

Where subsection 94(10) applies, the contributor will be considered a “connected contributor” to the trust and, if, as a result, there was a “resident beneficiary” at a specified time in the relevant prior taxation year of the trust, the trust and the resident beneficiary would, because of subsection 94(3), generally be jointly and severally, or solidarily, liable for Part I tax on the trust's income for the year. (For more details on the expression “solidarily”, please refer to the introductory commentary above on new section 94.)

Subparagraph 152(4)(b)(vi) of the Act is amended to ensure that a reassessment of a taxpayer arising out of the application of subsection 94(10) can be undertaken by the Canada Customs and Revenue Agency

within 3 years after the normal reassessment period of the taxpayer in respect of the taxpayer's relevant taxation year.

## **Deemed Contributor or Resident**

### **Contributor**

ITA

94(11) to (13)

Subsections 94(11) to (13) of the Act provide a set of related anti-avoidance rules that apply where it is reasonable to conclude that one of the reasons for a loan or transfer of property from a trust (the “original trust”), that is deemed under paragraph 94(3)(a) to be resident in Canada (or was deemed resident because of subsection (1) as it read in its application to taxation years that began before 2003 or would have been so deemed under either of those provisions if they had applied without regard to the period of time in which a contributor to the trust was resident in Canada), to another trust (the “transferee trust”) is to avoid or minimize the liability, of any entity under Part I of the Act, that arose, or that would otherwise have arisen, because of the application of subsection (3) (or because of subsection (1) as it read in its application to taxation years that began before 2003).

Where such a loan or transfer is made at a particular time, the original trust is deemed, under subsection 94(12), to be a resident contributor to the transferee trust for the purpose of applying this section in respect of the transferee trust.

Where such a loan or transfer is made at a particular time, an entity that is at that time a contributor to the original trust is deemed, under subsection 94(13), to be a contributor to the transferee trust and a connected contributor to the transferee trust (if at that time the entity is also a connected contributor to the original trust). For more information on the definitions “contributor” and “connected contributor” in subsection 94(1), see the commentary on those definitions.

Subsection 94(7) of the Act, generally provides that the liability of a “resident contributor” is limited by that contributor's recovery limit, as determined by reference to subsections 94(7) to (9). However, subsection 94(7) does not apply to an entity that is deemed, by subsection 94(12) or (13), to be a contributor or a resident contributor to the trust. For more information on the definition “resident contributor”

or subsections 94(3) and (7) to (9), see the commentary on those provisions.

## **Restricted Property**

ITA  
94(14)

Subsection 94(14) of the Act provides that a particular property (identified in prescribed form filed with the Minister of National Revenue in a timely manner by (or on behalf of) an entity) that is at any time held, loaned or transferred by the entity will not be treated as restricted property held, loaned or transferred at that time by the entity if the Minister is satisfied that the particular property (or property for which the particular property is substituted property) was not at any time acquired, held, loaned or transferred by the entity (or any entity with whom the entity does not at any time deal at arm's length) as part of a transaction or series of transactions or events a purpose of which was to permit any change in the value of the property of a corporation (that is, at any time, a closely-held corporation) to accrue to the particular property.

Subsection 94(14) is intended to provide relief only to the extent that the Minister is satisfied that an entity's holding, acquisition or transferring of a property that is otherwise restricted property was in no way part of a transaction (or series of transactions or events) designed in any way to permit the value of the property to be attributable in any way to a change in value of property of a corporation that at any time is a closely-held corporation.

For more details on the definitions "restricted property" and closely-held corporation", see the commentary on those provisions.

## **Arm's Length Dealing**

ITA  
94(15)

Subsection 94(15) of the Act ensures that the rules in section 251 are applicable in determining whether entities deal at arm's length with each other. The subsection provides that for the purposes of section 94, when determining whether a particular entity and another entity deal, at any time, with each other at arm's length, a reference in section 251 to the word "person" is to be read as a reference to the expression "entity" (as defined in subsection 94(1)).

## Anti-Avoidance – 150 Entities

ITA  
94(16)

Subsection 94(16) is an anti-avoidance provision that is relevant to the application of the definition “closely-held corporation” and paragraph (h) of the definition “exempt foreign trust” in subsection 94(1). These definitions, respectively, provide for different results based, in part, on the condition that there be at a particular time at least 150 beneficiaries under a trust or 150 shareholders of the capital stock of a corporation.

Subsection 94(16) provides that, if it can reasonably be considered that one of the main reasons that an entity is at any time a shareholder of a corporation or holds a capital interest in a trust is to cause the corporation or trust to satisfy the applicable condition, the corporation or the trust, as the case may be, is deemed not to have satisfied at that time that condition. Where subsection 94(16) applies in respect of a particular time and in respect of the corporation or trust, in the case of the corporation, it would be treated at that time as a closely-held corporation and in the case of the trust, it would not be treated at that time as an exempt foreign trust.

For more detail on the definitions “closely-held corporation” and “exempt foreign trust”, see the commentary on those definitions.

## Clause 16

### Foreign Investment Entities

ITA  
94.1

## OVERVIEW

### *Existing Rules*

Existing section 94.1 of the Act applies where a taxpayer has invested in an offshore investment fund and one of the main reasons for the investment is to reduce or defer the tax liability that would have applied to the income generated from the underlying assets of the fund if such income had been earned directly by the taxpayer. In these circumstances, existing section 94.1 generally requires an amount to be included in computing the taxpayer's income from the investment. This amount is determined, in general terms, by multiplying the cost amount



of the taxpayer's investment by a factor based on interest rates prescribed under Part XLIII of the *Income Tax Regulations*.

### *New Rules*

Section 94.1 is replaced by provisions in new sections 94.1 to 94.4, which contain rules governing the tax treatment of interests in foreign investment entities (FIEs), tracking entities and foreign insurance policies.

In computing a taxpayer's income for a taxation year, new subsection 94.1(4) will generally require an amount to be included in computing the taxpayer's income from the investment. This amount will be determined, in general terms, by multiplying the designated cost of the taxpayer's investment by a factor based on interest rates prescribed under paragraph 4301(b) of the *Income Tax Regulations*.

If a taxpayer elects and has sufficient information to comply, either new subsection 94.2(4) or 94.3(4) will apply in place of the rules in subsection 94.1(4) for computing income from the investment. However, in the case of interest in a tracking entity, subsection 94.3(4) will not be available, and in the case of an interest in a foreign insurance policy, only subsection 94.2(4) will apply.

Under subsection 94.2(4), a taxpayer must take into account the annual increase or decrease in the fair market value of the taxpayer's interest in computing the taxpayer's income from the interest.

Under subsection 94.3(4), a taxpayer is required to include the taxpayer's share of the FIE's income for each FIE taxation year that ends in the taxpayer's taxation year.

Section 94.4 is designed to prevent double taxation with respect to amounts included in income under any of sections 94.1 to 94.3.

New sections 94.1 to 94.4 apply to taxation years that begin after 2002.

The table below provides an overview of new sections 94.1 to 94.3 and related provisions.

Issue	Summary	References
1. Who is subject to the new FIE rules?	A. All taxpayers, except exempt taxpayers. Except as indicated in (C), below, FIE rules do not apply to non-resident taxpayers.	S.94.1(3), 94.2(3), (9) and (11).  “Exempt taxpayer” (s.94.1(1)).  Non-resident taxpayers: see also s.94.1(3) and 94.2(5).
	B. Partnerships with members resident in Canada must allocate FIE income to those members.	Existing section 96, including exception in s. 96(1.9). See also s. 94.2(6) for application to cases where partnership members become resident in Canada.
	C. Controlled foreign affiliates.	New s. 95(2)(g.3).
2. What property is subject to the new FIE rules?	A. If subsection 94.1(3) applies, Participating interests (other than exempt interests) in foreign investment entities. However, if no taxation year of a FIE has ended in the taxpayer's taxation year, the FIE rules do not apply to the taxpayer for the taxpayer's year in respect of the FIE.	S. 94.1(3) and the following definitions in s. 94.1(1): “entity”, “non-resident entity”, “foreign investment entity”, “exempt interest” and “participating interest”.
	B. If 94.1(3) does not apply, interests in non-resident entities, where the return on those interests tracks returns in respect of investment property. This property is not subject to s. 94.3.	S. 94.1(4) and 94.2(3) and (9). The definition “tracking entity” in 94.2(1) See also amended s. 91(1).

Issue	Summary	References
	C. Interests in certain foreign insurance policies. This property is subject only to s. 94.2, not s. 94.1 and 94.3.	S. 94.2(3), (10) and (11).
3. What is the difference in the tax treatment of FIE interests between ss. 94.1, 94.2 and 94.3?	A. Section 94.1. Taxes investor based on a prescribed rate of return.	S. 94.1(4).
	B. Section 94.2. Full appreciation/decline in fair market value of the investment is recognized on an annual basis.	S. 94.2(4). S. 94.2(20).
	C. Section 94.3. Taxes investor's "share" of a FIE's income (e.g., does not include FIE's share of unrealized gains).	S. 94.3(4).
4. How will foreign affiliates of taxpayers resident in Canada be treated under new FIE rules?	Subject to s. 94.2(9) (interests in tracking entities), a taxpayer's share of the capital stock of a controlled foreign affiliate is exempt from the new FIE rules. In certain cases, a taxpayer can elect to have a foreign affiliate treated as a controlled foreign affiliate.	Paragraph (a) of the definition "exempt interest".  Paragraphs 94.1(2)(h) and (i).
5. If a non-resident corporation that is a FIE pays out dividends, how are these dividends taxed?	A. General principle: existing rules apply.	Existing s. 90 and 113.

Issue	Summary	References
	B. Relief provided to prevent double taxation. This relief extends to taxable distribution from other FIEs (e.g., trusts).	S. 94.4.
6. In what circumstances is a taxpayer subject to any of sections 94.1 to 94.3, respectively?	A Requirement to use s. 94.1 where insufficient information to use s. 94.2 or s. 94.3.	S. 94.1(4), 94.2(3), 94.3(3).
	B. Election to use s. 94.2 available – interest must have readily ascertainable fair market value.	S. 94.2(3).
	C. Requirement to use s. 94.2 in the case of interests in foreign insurance policies.	S. 94.2(3), (10) and (11).
	D. Election to use s. 94.3 available – must have sufficient information.	S. 94.3(3).

## Definitions

### ITA

#### 94.1(1)

New subsection 94.1(1) of the Act defines a number of expressions for the purpose of section 94.1. These definitions are also relevant for the purposes of sections 94.2 and 94.3.

#### “arm’s length interest”

The definition “arm’s length interest” is relevant in determining whether a taxpayer’s particular participating interest is, under paragraph (e) of the definition “exempt interest” in subsection 94.1(1), an exempt interest and whether an interest has at any time a “readily obtainable fair



market value” as defined in subsection 94.2(1). For more information, see the commentary on those definitions.

A particular participating interest in a particular non-resident entity is an arm’s length interest at any time only if

- it is reasonable to conclude that there are at least 150 persons each of which holds participating interests in the particular non-resident entity that, at that time, are identical to the particular participating interest, and have a total fair market value of at least \$500,
- the total of all amounts each of which is the fair market value, at that time, of the particular participating interest or of a participating interest in the non-resident entity that is identical to the particular participating interest and that is held, at that time, by the taxpayer or an entity or individual with whom the taxpayer does not deal at arm’s length does not exceed 10% of the total of all amounts each of which is the fair market value, at that time, of a participating interest in the non-resident entity that is held, at that time, by any entity or individual and that is identical to the particular participating interest, and
- it is reasonable to conclude that the participating interests in the non-resident entity that are identical to the particular participating interest can normally be acquired and sold by members of the public in the open market.

### **“beneficiary”**

A reference in sections 94.1 to 94.3 to a “beneficiary” carries, except for the purpose of paragraph 94.2(11)(f) (i.e., a beneficiary in respect of an interest in an insurance policy), the meaning assigned by subsection 94(1). For more information, see the commentary on the definition “beneficiary” in subsection 94(1).

### **“carrying value”**

In applying sections 94.1 to 94.4 in respect of a taxpayer, the “carrying value” of a property held by a particular entity at any time means:

- the fair market value of the property at that time, if
  - the particular entity is an entity (referred to in this note as the “first entity”) in which the taxpayer holds at that time a

participating interest or is another entity in which the first entity holds at that time a direct or indirect interest,

- the taxpayer elects, by notifying the Minister in writing in the taxpayer's return of income for the taxpayer's taxation year that includes that time to have this paragraph apply to all of the particular entity's property, and
  - the property is property that would be valued for the purpose of the entity's "financial statements" (as defined in subsection 94.1(1)) as of that time if those financial statements included the property, if any, that is deemed by paragraph 94.1(2)(j) to be owned at that time by the entity
- in any other case, the amount at which the property would be valued for the purpose of the entity's financial statements as of that time if those financial statements included the property, if any, that is deemed by paragraph 94.1(2)(j) to be owned at that time by the entity.

The carrying value of property is relevant primarily for the purpose of determining whether a non-resident entity is a FIE. For more information, see the commentary on the definitions "foreign investment entity" and "financial statements".

It should also be noted that paragraph 94.1(2)(j) provides a "look-through" rule that can affect the properties considered to be owned by an entity and the carrying values of the entity's properties. In particular, the rule in paragraph 94.1(2)(j) can impute to an entity both ownership of property otherwise owned by certain other entities in which the entity has a significant interest, and the "net accounting income" (as defined in subsection 94.1(1)) and certain business activities of such other entities derived from such property. For the purposes of the look-through rule, the time at which the determination of carrying value is made is the end of the "taxation year" (as defined in subsection 94.1(1)) of the first tier non-resident entity (whether lower tier entities share the same taxation year or not). For more information, see the commentary to new paragraph 94.1(2)(j) and the definition "taxation year".

### **"designated cost"**

In computing a taxpayer's income for a taxation year from a participating interest of the taxpayer in a FIE, where subsection 94.1(4) applies, the taxpayer will be required to include the amount, determined

under that subsection, in computing the taxpayer's income from the investment. That amount is determined by multiplying the “designated cost” of the taxpayer's investment by a factor based on the interest rate prescribed under paragraph 4301(b) of the *Income Tax Regulations*.

The designated cost to a taxpayer at any time of a participating interest held at that time by the taxpayer in a foreign investment entity, is determined, in general terms, as follows:

- ADD the cost amount to the taxpayer of the participating interest at that time (determined without reference to certain provisions of the Act),
- ADD the amount of any previous income inclusions, of the taxpayer in respect of the participating interest, arising because of the application of subsection 94.1(4) for a previous taxation year that ends after 2002,
- ADD, if the participating interest was an offshore investment fund property (as defined in subsection 94.1(1) of the Act as it read in its application to taxation years that began before the 2003) of the taxpayer at the end of the taxpayer's last taxation year that began before 2003, certain amounts required to be included in computing the designated cost under “old” subsection 94.1(2),
- ADD, if the participating interest was acquired by the taxpayer before 2003, and was not an offshore investment fund property of the taxpayer at the end of the taxpayer's last taxation year that began before 2003, the amount, if any, by which the fair market value of the participating interest at the end of that last taxation year exceeds the cost amount to the taxpayer of the participating interest at the end of that last taxation year,
- ADD, if one or more particular amounts has been made available by a person to another person after the last 2002 taxation year of the foreign investment entity and before that time for the main purpose of increasing the value of the taxpayer's participating interest, the total of all amounts each of which is the amount, if any, by which each particular amount exceeds any increase in the cost amount to the taxpayer of the participating interest because of that particular amount,

- ADD, if the participating interest is acquired by the taxpayer after 2002, the amount, if any, by which the fair market value of the participating interest at the time it was so acquired exceeds the cost amount to the taxpayer of the participating interest at the time it was so acquired, and

SUBTRACT, if the participating interest was last acquired by the taxpayer before 2003, and was not an offshore investment fund property (as defined in subsection 94.1(1) as it read in its application to taxation years that began before 2003) of the taxpayer at the end of the taxpayer's last taxation year that began before 2003, the amount, if any, by which the cost amount to the taxpayer of the participating interest at the end of that last taxation year exceeds the fair market value of the participating interest at the end of that last taxation year.

### **“entity”**

An entity includes an association, a corporation, a fund, a joint venture, an organization, a partnership, a syndicate and a trust. It does not include a natural person.

### **“exempt business”**

The definition “exempt business” is relevant in determining whether a “non-resident entity” (as defined in subsection 94.1(1)) is carrying on an “investment business” (as defined in subsection 94.1(1)) and whether the non-resident is not a FIE. An investment business does not include an exempt business.

An exempt business of an entity at any time, in general terms, is a business (other than a business carried on by the entity principally with entities or individuals with whom the entity does not deal at arm's length, a business carried on by a trust that is an exempt foreign trust because of paragraph (h) of the definition “exempt foreign trust” in subsection 94(1), and a business carried on by the entity as a member, of a partnership, that is not a qualifying member of the partnership, or that would not be such a qualifying member if the entity were a person) that is carried on by the entity at that time and that, throughout the period (in its taxation year that includes that time) is

- carried on by the entity as a foreign bank, a trust company, a credit union, an insurance corporation or, if the entity is controlled by a taxpayer resident in Canada that is described in subparagraph



95(2.1)(a)(i), a trader or dealer in securities or commodities, the activities of which business are regulated under the laws of a specified country, or

- a business the principal purpose of which is to derive income from certain real estate businesses, certain leasing or licensing businesses, or businesses involved in the development of foreign and Canadian resource properties and timber resources.

The reference in this definition to a “permanent establishment” is intended to carry the meaning of that expression assigned by section 8201 of the Income Tax Regulations.

The reference in this definition to a “qualifying member” of a partnership is intended to carry the substantive meaning of that expression assigned by proposed subsection 248(1) of the Act, contained in the December 20, 2002 legislative proposals relating to income tax. For more detail on the proposed definition “qualifying member” in subsection 248(1) of the Act, see that provision and its commentary in the legislative proposals and explanatory notes published on December 20, 2002.

For more information generally, see the commentaries on the definitions “foreign investment entity” and “investment business” in subsection 94.1(1).

### **“exempt interest”**

The FIE income inclusion rules under any of subsections 94.1(4), 94.2(4) or 94.3(4) apply to a taxpayer for a year generally only where subsection 94.1(3) applies to the taxpayer. Subsection 94.1(3) will not apply to a taxpayer for a particular taxation year of the taxpayer in respect of a participating interest of the taxpayer in a non-resident entity if at the end of a taxation year of the non-resident entity that ends in the particular taxation year the taxpayer’s participating interest is an “exempt interest”. An exempt interest of a taxpayer in a non-resident entity is defined to mean at any time a particular participating interest held by the taxpayer in the non-resident entity if any of the following applies:

- The non-resident entity is a controlled foreign affiliate of the taxpayer (including an affiliate that is a controlled foreign affiliate because of an election under new paragraph 94.1(2)(h)); a “qualifying entity” (as defined in subsection 94.1(1) that is a

foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest (within the meaning assigned by paragraph 95(2)(m)); or a partnership.

- The taxpayer is a financial institution (as defined in subsection 142.2(1)) and the participating interest is a mark-to-market property (as defined in that same subsection) or a property described in an inventory of a business of the taxpayer, which inventory is valued, in computing the taxpayer's income from the business, in accordance with section 1801 of the *Income Tax Regulations*;
- The participating interest is a right
  - under an employee stock option plan, or similar agreement, to acquire a share of the capital stock of the non-resident entity,
  - granted by the non-resident entity, or another entity with which the non-resident entity does not deal at arm's length,
  - acquired by the taxpayer, at a time when the taxpayer dealt at arm's length with the entity that granted the right, and
  - acquired by the taxpayer solely because the taxpayer was an employee of the non-resident entity, or another entity with which the non-resident entity does not deal at arm's length;
- The non-resident entity is an entity (other than a trust that is an exempt foreign trust because of paragraph (h) of the definition "exempt foreign trust" in subsection 94(1)) all or substantially all of the carrying value of the property of which is attributable to properties that are shares of the capital stock of a corporation (that is not a foreign investment entity) that employs the taxpayer or that is related to another corporation that employs the taxpayer, and an amount that is all or substantially all of the non-resident entity's "payable net accounting income" (as defined in subsection 94.1(1)) becomes payable (as determined under paragraph 94.1(2)(o)) by it to its interest holders within specified times, and the taxpayer's share of that amount is included in computing the taxpayer's income for the taxpayer's taxation year that includes the time at which it became payable; or

- It is reasonable to conclude that the taxpayer had no tax avoidance motive (determined by reference to paragraphs 94.1(2)(k) to (n)) in respect of the particular participating interest, and
  - the particular participating interest is an “arm’s length interest” (as defined in subsection 94.1(1)) of the taxpayer, the non-resident entity is resident (determined by reference to paragraph 94.1(2)(g)) in a country in which there is a prescribed stock exchange, and participating interests in the non-resident entity that are identical to the particular participating interest are listed on a prescribed stock exchange, or
  - the non-resident entity is governed by the laws of one or more countries (other than a prescribed country) with which Canada has entered into a tax treaty, the non-resident entity exists, was (unless the entity was continued in any jurisdiction) formed or organized, or was last continued, under those laws, while it is governed by the laws of a country, the non-resident entity is under the tax treaty with that country resident in that country, and either

(I) the participating interest is an arm’s length interest of the taxpayer, or

(II) the non-resident entity is, under the tax treaty with the United States of America, resident in the United States of America, and throughout the period, in the taxpayer’s taxation year that includes that time, during which the taxpayer is resident in Canada, the taxpayer is a citizen of the United States of America and is liable for and subject to income tax in the United States of America for that taxation year because of that citizenship.

The definition “exempt interest” is also relevant in applying subsection 94.2(9) in determining whether subsection 94.1(4) or 94.2(4) will apply to a taxpayer’s interest in a “tracking entity” (as defined in subsection 94.2(1)). However, note that a taxpayer’s interest in a controlled foreign affiliate, or a qualifying entity (other than a partnership), will not avoid being subject to subsection 94.2(9) solely because it is an exempt interest. For more information, see the commentary on those provisions.

### “exempt property”

The definition “exempt property” is relevant in determining whether a property is an “investment property” (as defined in subsection 94.1(1)) and whether a “non-resident entity” (as defined in subsection 94.1(1)) is not a FIE. Except for the purposes of applying the definitions “investment business” in subsection 94.1(1) and “tracking entity” in subsection 94.2(1), investment property does not include exempt property.

In general terms, exempt property of a particular entity means at any time, in determining whether a particular taxpayer's interest in the particular entity is a participating interest in a FIE,

- under paragraph (a) of the definition, a property, of the particular entity, that is at that time used or held principally in a business (other than an investment business) carried on by the particular entity or a related entity,
- under paragraph (b) of the definition, indebtedness (that would be “excluded property”, as defined in subsection 95(1), of the particular entity if certain assumptions applied) owing by a debtor to the particular entity, where the particular entity and the debtor are foreign affiliates of the taxpayer or of another entity of which the taxpayer is a controlled foreign affiliate and in respect of which the taxpayer or the other entity, as the case may be, has a qualifying interest (as defined in subsection 95(2)(m)).

In addition, under paragraph (c) of the definition, exempt property means a property acquired by the particular entity within the 36 months preceding that time (or where written application has been made to the Minister of National Revenue by the taxpayer within 36 months of having acquired the property, within such longer period as the Minister considers reasonable in the circumstances) as a result of qualified activities. Those activities are

- the issuance of a debt or a participating interest in the particular entity;
- the disposition of property used in a business (other than an investment business) carried on by the particular entity or an entity related (otherwise than by reason of a right referred to in paragraph 251(5)(b)) to the particular entity;



- the disposition of a participating interest in another entity all or substantially all of the fair market value of the property of which is attributable to property used principally in a business (other than an investment business) carried on by the other entity or an entity related (otherwise than by reason of a right referred to in paragraph 251(5)(b)) to the other entity; and
- the accumulation of income of the particular entity derived from a business (other than an investment business) carried on by the particular entity or an entity related (otherwise than by reason of a right referred to in paragraph 251(5)(b)) to the particular entity,

The qualified activities also must have been undertaken for the purpose of

- acquiring property to be used principally in or making expenditures for the purpose of earning income from a business (other than an investment business) carried on by the entity or an entity related to the entity, or
- acquiring a participating interest that is a significant interest in another entity all or substantially all of the fair market value of the property of which is attributable to property used or held principally in the course of earning income from a business, other than an investment business, carried on by the other entity.

### **“exempt taxpayer”**

The rules in new sections 94.1 to 94.4 do not apply in respect of periods during which a taxpayer is an exempt taxpayer. For more information, see the commentary on paragraph 94.1(3)(a) and subsections 94.2(9) and (10).

An individual is an “exempt taxpayer” for a taxation year where the individual, before the end of the year, was a resident of Canada for a period of, or periods the total of which is, 60 months or less. (Individuals who have never been non-resident cannot fall within the 60-month exception.) This 60-month exemption for new immigrants to Canada is similar to an exemption in the rules for non-resident trusts in existing section 94.

Except as indicated below, tax-exempt entities to which subsection 149(1) applies are also exempt taxpayers. Retirement compensation

arrangements and qualifying environmental trusts for which alternative income tax rules are provided under Parts XI.3 and XII.4 and insurers to which paragraph 149(1)(t) applies are not exempt taxpayers.

An exempt taxpayer also includes a Canadian resident pooled fund trust under which the only beneficiaries (determined without reference to subsection 248(25) of the Act) are the tax-exempt persons described above that would qualify as exempt taxpayers with respect to another trust if they held their beneficial interests directly in that other trust. However, such a pooled fund trust would qualify as an exempt taxpayer only if all of the interests in the trust are “specified fixed interests” (As defined in subsection 94(1)).

The express reference to tax-exempt entities is generally of significance for the purposes of calculating Part I tax only in the context of the narrow circumstances to which new subsection 94.2(17) applies. That subsection contemplates a case where a taxpayer ceases to be an “exempt taxpayer” and subsequently becomes an “exempt taxpayer”. However, the reference to tax-exempt entities may also be of significance in the context of Part XI (foreign property limits), given that the application of sections 94.1 to 94.4 has an impact on the cost amount of participating interests in FIEs.

### **“financial statements”**

The definition “financial statements” is relevant primarily for the purpose of determining whether a non-resident entity is a FIE. For more information, see the commentary on the definitions “foreign investment entity” and “carrying value”.

In general, the financial statements, for a taxation, of an entity will be the balance sheet and statement of income provided by the entity to its investors if they are prepared in accordance with generally accepted accounting principles used for the taxation year in Canada or in accordance with generally accepted accounting principles that are substantially similar (including by reference to paragraph 94.1(2)(b)) to those used for the taxation year in Canada. Taxpayers, will however, be allowed to elect to treat an unconsolidated balance sheet and statement of income of an entity as its financial statements if they are prepared in accordance with those principles (or would be so prepared if those principles did not require consolidation).

More precisely, in applying sections 94.1 to 94.4 to a taxpayer, the financial statements, of a particular entity for a particular taxation year of the entity, are

- the balance sheet and the statement of income of the particular entity, if
  - the particular entity is an entity (referred to in this note as the “first entity”) in which the taxpayer holds, in the particular taxation year, a participating interest or is another entity in which the first entity has, in the particular taxation year, a direct or indirect interest,
  - the taxpayer elects (in the taxpayer’s return of income for the taxpayer’s taxation year in which the particular taxation year ends) to have this paragraph apply in respect of the particular entity and the participating interest, and
  - that balance sheet and statement of income would be prepared in accordance with generally accepted accounting principles used in Canada for the particular year or in accordance with generally accepted accounting principles that are substantially similar to those used in Canada if those principles did not require consolidation; and
- in any other case, the balance sheet and statement of income of the particular entity, if that balance sheet and statement of income are prepared for the particular taxation year in accordance with generally accepted accounting principles used for the taxation year in Canada or in accordance with generally accepted accounting principles that are substantially similar to those used for the taxation year in Canada.

### **“foreign bank”**

The definition “foreign bank” has the same meaning as in subsection 95(1). The expression is used in the definition “exempt business”.

### **“foreign investment entity”**

Under subsection 94.1(3), the new tax regime for FIEs in sections 94.1 to 94.4 generally applies only to participating interests in a “foreign investment entity” as defined in subsection 94.1(1).

A non-resident entity (as defined in subsection 94.1(1)) at any time will be a FIE at that time, unless any one of the following exceptions applies to the non-resident entity :

- at the end of its taxation year that includes that time, it is an “exempt foreign trust” (as defined in new subsection 94(1)) other than a trust that is an exempt foreign trust because of paragraph (h) of that definition or paragraph (g) (read without reference to its clause (iii)(A)) of that definition,
- at the end of its taxation year that includes that time, the carrying value of all of its investment property is not greater than one-half of the carrying value of all of its property, or
- throughout its taxation year that includes that time, its principal undertaking was the carrying on of a business that is not an investment business.

The new rules are designed so that, in the case of partnerships, members' shares of incomes and losses are allocated in accordance with section 96 (including new subsection 96(1.9), described in the commentary below).

For more information generally, see the commentary on the definitions “entity”, “exempt interest”, “non-resident entity”, “investment property” and “carrying value” in subsection 94.1(1) and “exempt foreign trust” in subsection 94(1). See also the commentary on paragraphs 94.1(2)(a), (b), (e) and (h) to (j) and paragraph 96(1)(d).

### **“investment business”**

The expression “investment business” is relevant in determining whether a non-resident entity is a FIE or a “qualifying entity”, as defined in subsection 94.1(1). An “investment business” of an entity at any time, means a business (other than a business that is at that time an exempt business) carried on by the entity (including, for greater certainty, a business carried on by the entity as a member of a partnership) at that time, if the principal purpose of the business is to derive any of the following income or profits:

- income (including interest, dividends, rents, royalties or any similar return on investment or any substitute for such a return) from property,



- income from the insurance or reinsurance of risks,
- income from the factoring of trade accounts receivable,
- profits from the disposition of investment property.

### **“investment property”**

The expression “investment property” includes a list of specified properties. Most of the specified properties (e.g., shares, partnership interests, real estate and resource properties) are also specified in the definition of the same expression in subsection 95(1). In addition to the properties also specified in the definition in subsection 95(1), “investment property” held by a particular entity includes:

- an interest in an organization, fund or other entity;
- most derivative financial products; and
- interests, options and rights in respect of the above properties.

It should be noted, however, that investment property of an entity does not include

- except for the purpose of applying the definition “investment business” in subsection 94.1(1) or the definition “tracking entity” in subsection 94.2(1), an “exempt property” (as defined in subsection 94.1(1)),
- except for the purpose of applying the definition “qualifying entity”, a “significant interest” (as defined in subsection 94.1(1)) in a “qualifying entity” (as defined in subsection 94.1(1)), an interest in a qualifying entity that has a significant interest in the entity, and debt owing by qualifying entities in which the entity has a significant interest or by a qualifying entity that has a significant interest in the entity, and
- certain exempt commodities and futures in respect of those exempt commodities.

The definition is relevant for the purpose of the determining whether a non-resident entity is a FIE. For more information, see the commentary

on the definitions “investment business”, “qualifying entity”, “significant interest”, and “exempt property” in subsection 94.1(1).

### **“net accounting income”**

The net accounting income of an entity for a taxation year means the amount that is its net income, before income taxes and extraordinary items, for the year reported in its financial statements for the year. For more information, see the commentary on the definition “financial statements” in subsection 94.1(1).

### **“non-resident entity”**

One of the requirements for an entity to be a FIE to which sections 94.1 to 94.4 apply is that the entity be a “non-resident entity”. In this regard, it should be noted that, under proposed subparagraph 94(3)(a)(iv), certain trusts that would otherwise be non-resident are deemed (for certain limited purposes including the definition “non-resident entity”) to be resident in Canada for taxation years in which the trust has a resident contributor or a resident beneficiary. For more information, see the commentary to new subsection 94(3).

In addition to non-resident corporations and trusts, a “non-resident entity” includes at any time any other type of entity that at that time

- exists, was (unless the entity was continued in any jurisdiction) formed or organized, or was last continued under the laws of a country or a political subdivision of a country other than Canada, or
- is governed under the of a country or a political subdivision of a country other than Canada.

### **“participating interest”**

A “participating interest” in an entity means a share of the capital stock of corporation, a specified interest (as defined in subsection 94.1(1)) in a trust and an interest in any other type of entity.

It also includes a property that is (under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently) convertible into, exchangeable for, or confers a right to acquire

- such a share, specified interest or other interest, or
- a property (other than money) the fair market value of which is determined primarily by reference to the fair market value of such a share, interest as a beneficiary or other interest in an entity.

For a related rule that applies in determining whether an interest is a participating interest, see the commentary on paragraph 94.1(2)(s).

### **“payable net accounting income”**

The payable net accounting income, of an entity for a taxation year of the entity, means its net income, after income taxes and extraordinary items, for the year reported in its “financial statements” (as defined in subsection 94.1(1)) for the year.

This definition is relevant in determining whether an interest in a non-resident entity is an “exempt interest” (as defined in subsection 94.1(1)) in the entity. In particular, it is relevant in applying paragraph (d) of the definition “exempt interest” in subsection 94.1(1) and paragraphs 94.1(2)(m) and (n).

### **“qualifying entity”**

A “qualifying entity” in a period means a particular entity that is a partnership or a corporation all or substantially all of the “carrying value” (as defined in subsection 94.1(1)) of the property of which is, throughout the period, attributable to the carrying value of property that is:

- property other than “investment property” (as defined in subsection 94.1(1)),
- investment property that is a participating interest in or debt of another entity if the other entity is an entity whose principal business is not an investment business and the particular entity has either a significant interest in the other entity or a strategic interest in the other entity,
- investment property in respect of which the particular entity establishes that the property or proceeds from the disposition of the property is to be used by the particular entity for the purpose of acquiring property described in the two paragraphs above,

- investment property that is held by the particular entity if the particular property (or other property for which the particular property is substituted property) was last acquired by the particular entity within 36 months before the end of the period (or, where applicable conditions are met, within such longer period as the Minister considers reasonable in the circumstances), as a result of qualifying activities.

For this purpose, qualifying activities are

- the issuance of a debt or a participating interest in the entity,
- the disposition of property described in any of paragraphs (a) to (c) of the definition “qualifying entity”, and
- the accumulation of income of the entity.

The qualifying activities must also have been made for the purpose of acquiring property that, if owned by the entity, would be property described in paragraph (a) to (c) of the definition of “qualifying entity”.

For the purpose of applying this definition, an entity will be considered to have a strategic interest in another entity where the entity participates in or has established a plan of action for participating in the management and control of the other entity by reason of its status as a holder of a significant number (not to be confused with the “significant interest” definition) of participating interests in the other entity (in comparison with the number of participating interests held by each holder of interests in the entity) or an agreement with other such significant interest holders.

In establishing if an entity actively participates in or exercises a significant influence over the governance or the management of an other entity the following facts (among others) will be considered:

- whether the entity, alone or in alliance with others, appoints members of the board of directors and management;
- whether the entity, alone or in alliance with others, significantly influences the appointment of members of the board of directors and management; and



- whether the entity, alone or in alliance with others, is actively involved in the strategic planning for the entity.

In determining if an entity is carrying out a plan of action for the purpose of obtaining its objective of actively participating in or exercising significant influence over the governance or the management of another entity, all factors will be considered. For example, an entity's board-approved plan of action, board minutes, investment studies and other material relating to the strategic investment will be considered. As well, evidence that increasing numbers of shares of the other entity are being bought or that property is being sold in order to raise money to acquire such shares will be considered important factors. The entity's investment history and patterns will also be considered.

Finally, it should be noted that under paragraph 94.1(2)(r), the definition “qualifying entity” in subsection (1) does not apply in determining whether a taxpayer has a participating interest in a FIE, if the Minister sends a written demand to a taxpayer requesting additional information for the purpose of enabling the Minister to determine whether an entity is a qualifying entity, and information satisfactory to the Minister to make the determination is not received by the Minister within 60 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand.

For more information, see the commentary on paragraph 94.1(2)(r) and on the definitions “carrying value”, “significant interest” and “investment property” in subsection 94.1(1).

### **“significant interest”**

An entity is considered to have a significant interest in a corporation, partnership, or non-discretionary trust if the entity or a group of entities comprised of the entity and entities related to the entity holds shares or interests in the corporation, partnership or trust that have a fair market value equal to 25% or more of the fair market value of all the shares or interests in the corporation, partnership or trust and, in the case of a corporation, the entity or the group of entities comprised of the entity and the entities related to the entity has shares entitling the entity to cast at least 25% of votes at an annual shareholders' meeting of the corporation.

In these circumstances, the entity's significant interest will be its share of the capital stock of the corporation, its interest as a member of the

partnership or its interest as a beneficiary under the trust, as the case may be.

### **“specified interest”**

The definition “specified interest” applies in determining whether an entity or individual has a “participating interest” (as defined in subsection 94.1(1)) in a non-resident entity that is a trust. A specified interest at any time of an entity or individual in a trust, means, an interest of the entity or individual as a beneficiary under the trust if

- The trust is at that time an exempt foreign trust because of paragraph (g) or (h) of the definition “exempt foreign trust” in subsection 94(1). As a result, an interest in a foreign commercial investment trust or in certain employee benefit arrangements will generally be subject to the income computation requirements in sections 94.1 to 94.4 if the trusts are FIEs or tracking entities; or
- The interest includes at that time a right of the entity or individual as a beneficiary under the trust to receive at or after that time income or capital of the trust. However, such an interest will not be treated as a participating interest if the the entity or individual is at that time a testamentary beneficiary, under the trust, as defined by subsection 94(1) (i.e., is a beneficiary under the trust solely because of certain rights to use or receive trust property only after the death of specified entities or individuals).

### **“specified party”**

The definition “specified party” is relevant in determining whether a taxpayer has an avoidance motive in respect of a participating interest in a FIE. This determination is relevant to applying the definition “exempt interest” in subsection 94.1(1). For more information, see the commentary on the definition “exempt interest”.

A specified party in respect of a particular individual or particular entity, as the case may be, means another individual or other entity that does not deal at arm’s length with the particular individual or the particular entity, as the case may be.

## “taxation year”

The “taxation year” of a non-resident entity that is a corporation or an individual is generally determined in accordance with subsection 249(1) and paragraph 250.1(a). Where the non-resident entity is not an individual or a corporation, this definition provides that the entity’s taxation year means:

- in respect of a business or property of the non-resident entity for which the accounts of the non-resident entity are ordinarily made up, the period that would be determined under section 249.1 in respect of the non-resident entity if the non-resident entity were a corporation, and
- in any other case, a calendar year.

## Rules of Application

ITA

94.1(2)

Subsection 94.1(2) sets out a number of rules for the purposes of applying sections 94.1 to 94.4 in respect of a particular participating interest, in a particular non-resident entity, held by a taxpayer in a particular taxation year of the taxpayer (and in respect of any other participating interests in the particular non-resident entity that are identical to the participating interest and that are held by the taxpayer in the particular taxation year). These rules are relevant, for example, in determining whether the particular non-resident entity is a FIE and whether the particular participating interest is an “exempt interest”.

### *Determining Whether Entity is a FIE*

New paragraph 94.1(2)(a) contains rules for applying the financial statements (as defined in subsection 94.1(1)) of an entity in determining whether a particular non-resident entity, in which a taxpayer holds a particular participating interest, is a FIE.

If the financial statements of an entity (referred to in this note as the “first entity”) for a taxation year (referred to in the commentary on paragraph 94.1(2)(a) as the “specified year”) of the first entity reflect property, indebtedness, income or losses of another entity,

- the business and non-business activities for the specified year carried on by the other entity, the net accounting income for the specified year determined for the other entity from those activities, and the property and indebtedness for the specified year owned by or owed by, as the case may be, the other entity are deemed for the specified year to be carried on by, determined for, owned by or owed by, as the case may be, the first entity, and
- an exempt business of the other entity at any time in the specified year is, if it is a business the activities of which are deemed by subparagraph 94.2(a)(i) to be carried on by the first entity, deemed to be an exempt business of the first entity at that time in the specified year;

Paragraph 94.1(2)(a) is relevant in applying, for example, the definition “carrying value” in subsection 94.1(1), when determining whether the non-resident entity is a FIE because of the carrying value of its investment property.

For more information, see the commentary on the definitions “carrying value”, “foreign investment entity” and “investment property” in subsection 94.1(1). See also, the commentary on paragraph 94.1(2)(b), for more information on determining whether accounting principles are substantially similar to Canadian GAAP, and the commentary on paragraph 94.1(2)(j), for more information on the look-through rule for significant interests.

### *GAAP substantially similar to Canadian GAAP*

Paragraph 94.1(2)(b) provides that generally accepted accounting principles used for a taxation year in the United States of America or in countries that are members of the European Union are, for greater certainty, considered to be substantially similar to those used in Canada for that taxation year.

### *Designated Cost*

Paragraph 94.1(2)(c) applies in determining, at any time in a particular taxation year, the designated cost to a taxpayer of a participating interest of the taxpayer that is a specified interest (as defined by subsection 94.1(1)) in a trust. However, the rule only applies where the trust is an exempt foreign trust (as defined by subsection 94(1)) because of paragraph (g) of that definition. Under paragraph 94.1(2)(c), the cost at that time to the taxpayer of the participating interest is deemed to be the



total of all amounts each of which is the fair market value, immediately before it was acquired by the trust, of a specified property. For this purpose, specified property is property that is held by the trust at that time and that may be reasonably be considered to be held for the purpose of satisfying a right (other than a right under an arrangement to which subsection 7(2) or (6) of the Act applies) of the taxpayer that is included in specified interest.

### *Characterization of Income from FIE Interest*

Paragraph 94.1(2)(d) provides a special rules for determining whether a taxpayer's income for a taxation year from the application of subsection 94.1(4) or 94.3(4) will be treated as income from a source outside Canada. Paragraph 94.1(2)(d) provides that in applying subsections 94.1(4) and 94.3(4) to a taxpayer (that is a trust) for a particular taxation year of the taxpayer and in respect of a participating interest of the taxpayer in a non-resident entity, the reference in those subsections to "as income from property from a property that is the participating interest" is to be read as a reference to the expression "as income from property from a property that is a source outside Canada that is the participating interest". However, this special rule applies only if the portion of the net accounting income of the non-resident entity, from sources outside Canada, for its last taxation year that ends in the particular taxation exceeds 90% of the total net accounting income of the non-resident entity for that last taxation year.

Paragraphs 94.2(2)(f) and (g) provide similar rules that apply with respect to subsection 94.2(4). For more detail, see the commentary on those paragraphs.

The application of paragraph 94.1(2)(d) and paragraphs 94.2(2)(f) and (g) in respect of a participating interest of a taxpayer will not be relevant in determining a taxpayer's eligibility for a foreign tax credit under section 126 of the Act. In this regard, see the commentary below on subsections 94.3(2) and 126(1.2). Rather, these paragraphs provide relief to trusts resident in Canada that hold participating interests in a FIE and that make payable to their non-resident beneficiaries all or part of the trusts' incomes arising under any of subsections 94.1(4), 94.2(4) or 94.3(4). Where paragraph 94.1(2)(d) or 94.2(2)(f) or (g) applies and the terms of the trust permit amounts of deemed income of the trust to be made payable to beneficiaries, the amounts of such trust income arising under any of subsections 94.1(4), 94.2(4) or 94.3(4) and made payable to non-resident beneficiaries of the trust may qualify for reduced withholding if the non-resident beneficiary is resident in a

country with which Canada has entered into a tax treaty and the tax treaty contains a provision permitting such a reduction in withholding.

### *Investment Business*

Under paragraph 94.1(2)(e), a determination of whether the principal business of an entity for a taxation year of the entity is an investment business is made by reference to:

- subject to the rules below, the relevant facts and circumstances, including the utilization of assets and employees, expenditures made and the revenue of the entity, or
- if the taxpayer elects, by reference to the entity's "net accounting income" (as defined in subsection 94.1(1)) from investment property and investment businesses,

Under subparagraph 94.1(2)(e)(iii), if the Minister of National Revenue sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to determine whether the principal business of the entity is in that taxation year an investment business, and information satisfactory to the Minister to make the determination is not received by the Minister within 60 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand, the principal business of the entity for that taxation year is deemed to be an investment business.

### *Arm's Length and Related*

Under paragraph 94.1(2)(f), in determining whether an entity or natural person and another entity or natural person are related to each other or deal at arm's length with each other, a person referred to in section 251 includes an entity.

### *Residence of an Entity - Special Case*

New paragraph 94.1(2)(g) of the Act applies in determining whether a taxpayer's participating interest (as defined in subsection 94.1(1)) in a FIE is an "exempt interest" (as defined in subsection 94.1(1)). Paragraph 94.1(2)(g) provides that in applying subparagraph (e)(i) of the definition "exempt interest", if the FIE is not a corporation, a partnership or a trust, it is deemed not to be resident in a particular country, unless

- the particular country is a country other than a prescribed country,

- the FIE is governed, and exists, was (unless the FIE was continued in any jurisdiction) formed or organized, or was last continued under the laws of, the particular country and,
- the FIE is liable, under the laws of the particular country, to pay an income or profits tax imposed by the government of the particular country on all of its income, profits or gains.

If the paragraph 94.1(2)(g) applies so that the FIE is not considered resident in a particular country for the purpose of subparagraph (e)(i) of the definition “exempt interest”, then the taxpayer would not be able to rely upon that paragraph in order to qualify the participating interest as an exempt interest.

### *Entity Treated as Controlled Foreign Affiliate*

New paragraph 94.1(2)(h) of the Act permits a taxpayer to make an irrevocable election to treat a foreign affiliate, of the taxpayer, that is a foreign investment entity (including an affiliate the shares which are held by the taxpayer's controlled foreign affiliate) as a controlled foreign affiliate for a particular taxation year and subsequent taxation years. This one-time election is available only if:

- the taxpayer holds a participating interest in the foreign affiliate and a taxation year of the foreign affiliate ends (or the first taxation year of the foreign affiliate begins) in the taxpayer's election year a (or controlled foreign affiliate of the taxpayer holds a participating interest in the foreign affiliate and a taxation year of the foreign affiliate ends (or the first taxation year of the foreign affiliate begins) in a taxation year of the controlled foreign affiliate that ends in the taxpayer's election year), and
- the taxpayer has a “qualifying interest” (as defined in paragraph 95(2)(m)) in the affiliate.

The election must be made in prescribed form in the taxpayer's tax return for the year (except where the taxpayer is a partnership, in which case special rules apply under paragraph 96(1)(d)). However, under paragraph 94.1(2)(i), described in the commentary below, the election may be rendered invalid in the event that the taxpayer cannot provide sufficient information to the Minister of National Revenue for the Minister to be able to determine amounts required to be included in the taxpayer's income under section 91. In addition, the election ceases to

have effect if the corporation ceases to be a foreign affiliate of the taxpayer.

In the period during which an election under paragraph 94.1(2)(h) is effective, a foreign affiliate of a taxpayer is deemed to be a controlled foreign affiliate of the taxpayer. As a result, a share issued by the affiliate to the taxpayer would be an “exempt interest” under the definition in subsection 94.1(1). Sections 94.1 to 94.4 generally would not apply to the taxpayer's participating interest in the affiliate. However, the foreign accrual property income (FAPI) rules would apply and the taxpayer would be required to include in income under section 91 a percentage of any FAPI derived by the affiliate in the year. Notwithstanding an election under paragraph 94.1(2)(h), section 94.2 may still apply in the event that a taxpayer's interest in a controlled foreign affiliate is a tracked interest to which subsection 94.2(9) applies.

#### *Demand for Information – CFA election*

Under paragraph 94.1(2)(i), an election made by a taxpayer under subparagraph 94.1(2)(h)(iii) is, other than for the purposes of applying paragraph 94.1(2)(i) and that subparagraph, deemed never to have been made, if the Minister sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to make a determination referred to in one of those paragraphs, and information satisfactory to the Minister to make the determination is not received by the Minister within 60 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand.

The determination referred to in paragraph 94.1(2)(i) concerns an amount that would, if the Act were read without reference to that paragraph, be required to be added or deducted (otherwise than under subsection 104(13)) in computing the taxpayer's income for the year because of the application of section 91 and an election under paragraph 94.1(2)(h) in respect of a foreign affiliate.

#### *Look-through Rule – Significant Interests*

A particular non-resident entity is a FIE at any time if the carrying value of all of the entity's “investment property” is more than 50% of the “carrying value” of all its property at the end of the entity's taxation year that includes that time and none of the other exceptions in the definition “foreign investment entity” applies.



New paragraph 94.1(2)(j) is relevant in determining whether a taxpayer's participating interest in the particular non-resident entity is a participating interest in a FIE. The paragraph applies if the taxpayer has made a valid election under 94.1(2)(j) in respect of the participating interest of the taxpayer, and a specified entity (i.e., the particular non-resident entity or another entity in which the particular non-resident entity has, directly or indirectly, an interest)) has a "significant interest" (as defined in subsection 94.1(1)) in another entity ("the investee"), that is a corporation, partnership or non-discretionary trust. In this case, and provided that the financial statements of the specified entity do not reflect property or indebtedness of the other entity, in determining whether the particular non-resident entity is a foreign investment entity (and if the taxpayer stipulates in the election, in determining also whether the particular non-resident entity is a qualifying entity), the following rules apply:

- In determining the carrying value of the specified entity's property, the carrying values of its participating interests in the investee are deemed to be nil. Debt owing to the specified entity by the investee (other than debt acquired in the ordinary course of a business other than an investment business of the specified entity) is also deemed to have a carrying value to the specified entity of nil, and the net accounting income of the specified entity is also deemed to be nil to the extent that it is derived from debt or participating interests of the specified entity that are deemed to be nil.
- The specified entity is deemed to own the property of the investee. Each such deemed owned property is deemed to have a carrying value to the specified entity based on the product obtained by multiplying the property's carrying value to the investee by the specified entity's proportional ownership of the investee's property. In general terms, this proportional ownership is the quotient obtained by dividing:
  - the amount that is the fair market value of the specified entity's shares and certain debt issued by the investee, by
  - the amount that is the total fair market value of shares and certain debt issued by the investee entity.
- In general terms, the activities carried on by the investee (including an exempt business of the investee) using the property deemed to be owned by the specified entity, and the investee's net accounting

income derived from those activities, are deemed to be those of the specified entity to the extent of that proportional ownership.

If the taxpayer notifies the Minister of National Revenue in writing of its intention to value the specified entity's property at its fair market value in accordance with paragraph (a) of the definition "carrying value" in subsection 94.1(1), the property of the investee must also be valued on that basis.

If there are tiers of entities each of which has a significant interest in the other, paragraph 94.1(2)(j) operates to deem each higher tier entity to own properties of the immediately lower tier entities on an iterative basis. For example, assume a non-resident entity (Foreignco-1) owns 100% of the shares in Foreignco-2, which in turn owns 100% of shares in Foreignco-3 and that Foreignco-1, Foreignco-2 and Foreignco-3 have identical taxation year-ends. The carrying values from properties in Foreignco-3 would, under paragraph 94.1(2)(j), become the carrying values of properties in Foreignco-2. Because paragraph 94.1(2)(j) operates on an iterative basis, the carrying value of those properties would be considered to be the carrying values of properties held by Foreignco-1.

The example below illustrates the operation of paragraph 94.1(2)(j).

**Example**

- 1. *Jean, who resides in Canada, holds shares in Foreignco, a non-resident corporation that is not a controlled foreign affiliate of Jean. Foreignco's principal activity is the carrying on of investment activities on behalf of its shareholders. Foreignco prepares its financial statements in accordance with accounting principles substantially similar to generally accepted accounting principles used in Canada.*
- 2. *The carrying values of Foreignco's assets at the end of its taxation year ending in Jean's year are as follows:*

<i>guaranteed investment certificate shares of XYZ Inc. in which Foreignco</i>	<i>\$10,000</i>
<i>has a significant interest</i>	<i>\$20,000</i>
<i>shares of ABC Inc. in which Foreignco does not have a significant interest</i>	<i>\$ 5,000</i>
<i>cash</i>	<i>\$ 4,000</i>
<i>Total assets</i>	<i>\$39,000</i>

3. *XYZ Inc. owns assets at that time that are used in the course of carrying on an active business, with a carrying value of \$80,000. It also has investment property with a carrying value of \$15,000.*
4. *The fair market value of the shares of XYZ Inc. held by Foreignco is \$40,000 while the fair market value of all the issued and outstanding shares of XYZ Inc. is \$100,000 at that time.*

## **Results**

1. *The guaranteed investment certificate, cash, and the shares of XYZ Inc. and ABC Inc. are all investment property by virtue of the definition "investment property" in subsection 94.1(1).*
2. *However, since Foreignco owns a significant interest in XYZ Inc., the special look-through rule in new paragraph 94.1(2)(j) applies. Under this look-through rule the carrying value of Foreignco's shares in XYZ Inc. is deemed to be nil. Instead, Foreignco is deemed to own a portion of the property that XYZ Inc. owns.*
3. *The carrying value of the XYZ property deemed to be owned by Foreignco is 40% of its carrying value to XYZ, since Foreignco's percentage ownership of shares is 40%.*
4. *Consequently, the carrying values of the investment property of Foreignco are:*

<i>guaranteed investment certificate</i>	<i>\$10,000</i>
<i>shares of XYZ Inc.</i>	<i>nil</i>
<i>shares of ABC Inc.</i>	<i>\$ 5,000</i>
<i>cash</i>	<i>\$ 4,000</i>
<i>investment property of XYZ Inc. (40% of \$15,000)</i>	<i><u>\$ 6,000</u></i>
<i>Total</i>	<i>\$25,000</i>

5. *The total carrying value of the assets of Foreignco is:*

<i>Investment property (see above)</i>	<i>\$ 25,000</i>
<i>assets of XYZ Inc. (other than investment property)</i>	
<i>(40% of \$80,000)</i>	<i><u>\$ 32,000</u></i>
<i>Total</i>	<i>\$ 57,000</i>

6. *As a result, Foreignco is not a FIE because less than 50% of the carrying value of its property is investment property.*

*Tax Avoidance Motive*

New paragraph 94.1(2)(k) of the Act sets out the conditions under which a taxpayer will be considered to have a tax avoidance motive in respect of a participating interest in a FIE. Subject to new paragraphs 94.1(2)(m) and (n) (described in the commentary below), a tax avoidance motive will be considered to exist only if it is reasonable to conclude that the main reasons for the taxpayer acquiring, holding or having the particular participating interest were to permit the taxpayer to achieve the following two objectives:

- to derive a benefit the value of which can be attributed principally, directly or indirectly, to income derived from investment property, to profits or gains from the disposition of investment property, or to an increase in value of investment property, and
- the deferral or reduction of the amount of tax payable on that income or those profits or gains.

*Factors Considered in Tax Avoidance Motive*

New paragraph 94.1(2)(l) of the Act sets out factors to be considered in determining whether there is a tax avoidance motive for a taxpayer acquiring an interest in a non-resident entity. Those factors are similar to the ones in existing subsection 94.1(1). However, the form and the terms and conditions governing the taxpayer's interest in a non-resident entity are to be taken into account as well. Note that a tax avoidance motive may exist whether the non-resident entity is resident in a "tax haven" or not. The factors are as follows:

- the nature, organization and operation of the non-resident entity and any FIE in which it or a specified party (as defined in subsection 94.1(1)) in respect of it has a direct or indirect interest,
- the nature, organization and operation of any FIE in which the taxpayer or a specified party in respect of the taxpayer has a direct or indirect interest,
- the form of and the terms and the conditions governing the direct or indirect interests described above,
- the extent to which and the time at which the particular non-resident entity, or an entity in which a direct or indirect interest



described above is held, is subject to an income or profits tax on its income, profits and gains,

- the extent to which and the time at which an entity that holds a direct or indirect interest described above is subject to an income tax or profits tax on the entity's share of the income, profits and gains of the entity in which the direct or indirect interest is held and
- the amount of tax that would have been payable by the taxpayer under this Part had the taxpayer earned the income or realized the profits or gains in respect of the investment property referred to in subparagraph 94.1(2)(k)(i) at the time that the income was earned, or the profits or gains were realized, by the entities that owned or held the investment property.

### *No Tax Avoidance Motive*

New paragraphs 94.1(2)(m) and (n) provide two situations where a taxpayer will not be considered to have a tax avoidance motive in respect of a participating interest in a non-resident entity held by the taxpayer in a taxation year:

- if the non-resident entity (and each other foreign investment entity, in which the non-resident entity has a direct or indirect interest) makes payable (determined by reference to paragraph 94.1(2)(o)) all or substantially all of its "payable net accounting income" (as defined in subsection 94.1(1)) for its taxation year that ends in the particular taxation to its interest holders within 120 days after the end of its taxation year, and the taxpayer's share of that amount is included in computing the taxpayer's income, profit or gains for the taxpayer's taxation year that includes the time at which the amount became payable, and
- if the non-resident entity is a "Regulated Investment Company" for the purposes of sections 851(b) and 852(a) of the United States *Internal Revenue Code* or a "Real Estate Investment Trust" for the purposes of sections 856(c) and 857(b) of that Code, and the taxpayer includes, in computing the taxpayer's income for that taxation year of the taxpayer, the amount of income that became payable (determined by reference to paragraph 94.1(2)(o)) by the particular non-resident entity to the taxpayer in that taxation year of the taxpayer.

For more detail on the definition “payable net accounting income” in subsection 94.1(1), see the commentary on that definition.

### *Amounts Payable*

Under paragraph 94.1(2)(o), an amount is deemed not to have become payable at any time to an entity or individual unless it was paid on or before that time to the entity or individual, as the case may be, or the entity or individual, as the case may be, was entitled on or before that time to enforce payment of it. This rule is relevant in applying paragraph (d) of the definition “exempt interest” in subsection 94.1(1), paragraphs 94.1(2)(m) and (n), the definition “mark-to-market formula” in subsection 94.2(1), and subsections 94.4(2) and (4).

### *Demands for Information*

Under paragraphs 94.1(2)(p) to (r) a number of provisions in section 94.1 will not apply in respect of a taxpayer’s participating interest in a non-resident entity, if the Minister sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to make a determination referred to in one of those paragraphs, and information satisfactory to the Minister to make the determination is not received by the Minister within 60 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand.

The determinations referred to in paragraph 94.1(2)(p) to (r) are in respect of the definitions “exempt property”, “foreign investment entity” and “qualifying entity” in subsection 94.1(1), respectively.

### *Participating Interests – Special Case*

Paragraph 94.1(2)(s) applies in determining whether an interest is a participating interest. Under that paragraph, if at any time a taxpayer has a participating interest in a particular foreign investment entity and the taxpayer has at that time a participating interest (referred to in that paragraph and this commentary as the “indirect participating interest”) in another non-resident entity solely because the particular foreign investment entity has at that time a participating interest in that other non-resident entity, then the indirect participating interest is deemed not to be a participating interest of the taxpayer at that time.

Paragraph 94.1(2)(s) provides relief only where the conditions attached to a taxpayer's participating interest in a FIE are such that the interest may also be a participating interest in another non-resident entity in which the FIE holds an interest and in which the taxpayer does not directly hold an interest. Paragraph 94.1(2)(s) would not apply to a participating interest where the taxpayer holds the participating interest directly in the other non-resident entity – in these circumstances, the taxpayer would be required to determine whether the participating interest in the other non-resident entity is a participating interest in a FIE.

### **Conditions for Application of Tax Regime for Foreign Investment Entities**

ITA

94.1(3)

New subsection 94.1(3) of the Act sets out the common conditions for the application of the FIE rules in section 94.1(3) (prescribed rate of return regime) and 94.2(4) (mark-to-market regime). For the prescribed rate of return or mark-to-market regimes to apply to a taxpayer for a particular taxation year of the taxpayer in respect of a participating interest held in the particular year by the taxpayer in a non-resident entity (other than a tracking interest or a foreign insurance product – for more information see the commentary on subsection 94.2(3)), all of the following conditions set out in subsection 94.1(3) must be satisfied:

- the taxpayer is not an “exempt taxpayer” for the taxpayer's particular taxation year;
- the taxpayer held the participating interest at the end of a taxation year of the non-resident entity that ends in the taxpayer's particular taxation year; and
- at the end of that taxation year of the non-resident entity, the interest was a participating interest in a FIE and was not an exempt interest.

## Income Inclusion – Prescribed Rate of Return Regime

ITA

### 94.1(4)

Subsection 94.1(4) applies to a taxpayer resident in Canada for a taxation year of the taxpayer in respect of a participating interest in a non-resident entity if subsection 94.1(3) or 94.2(9) applies (and subsections 94.2(3) and 94.3(3) do not apply) to the taxpayer for the taxation year in respect of a participating interest.

Where subsection 94.1(4) applies, the taxpayer is required to include (as income from property from a property that is the participating interest) in computing the taxpayer's income for that taxation year the total of all amounts each of which, is in respect of each month in that taxation year, at the end of which month the taxpayer holds the participating interest, the product obtained by multiplying

- the designated cost (as defined in subsection 94.1(1)), to the taxpayer of the participating interest, at the end of the month,

by

- the quotient obtained when the rate of interest prescribed, in respect of amounts required by this Act to be paid by the Minister, for the quarterly period that includes that month is divided by 12.

For this purpose, the rate of interest will be that determined under paragraph 4301(b) of the Regulations. That rate, in very general terms, is the 3-month average Treasury bill rate + 2 percentage points.

For more information on the definition “designated cost” in subsection 94.1(1), see the commentary on that definition. For more information on subsection 94.2(3), see the commentary on that subsection.

ITA

### 94.1(5)

New subsection 94.1(5) applies where a taxpayer disposes of an interest in a non-resident entity at a particular time in a particular taxation year. If subsection 94.1(4) applied for the purpose of computing the taxpayer's income, for any taxation year of the taxpayer that began on or before the particular time, in respect of the participating interest, the taxpayer may be permitted to deduct an amount equal to the lesser of



- the amount, if any, by which the total of the taxpayer's income inclusions under subsection 94.1(4) in respect of the interest (since its last acquisition by the taxpayer) exceeds the total deductions available to the taxpayer in respect of the interest under paragraph 94.4(2)(a), and
- the taxpayer's capital loss for the particular taxation year from the disposition of the participating interest (determined without reference to paragraph 94.1(5)(b) and subparagraph 40(2)(g)(i)), be.

Where a deduction is claimed by the taxpayer under paragraph 94.1(5)(a) in computing the taxpayer's income for the particular taxation year, the taxpayer's capital loss for the taxation year from the disposition of the participating interest (determined without reference to paragraph 94.1(5)(b) and subparagraph 40(2)(g)(i) is reduced by the amount of that deduction.

## **Foreign Investment Entities – Mark-to-market**

ITA  
94.2

New section 94.2 of the Act sets out new rules for the taxation of interests in FIEs where subsections 94.1(4) and 94.3(3) do not apply.

Except as otherwise indicated, section 94.2 applies to taxation years that begin after 2002.

## **Definitions**

ITA  
94.2(1)

New subsection 94.2(1) of the Act sets out a number of definitions and provides that those definitions and the definitions in subsection 94.1(1) apply for the purposes of section 94.2.

## **“deferral amount”**

The deferral amount of a taxpayer generally represents the gain or loss (in the event that the interest was capital property, one half of the gain or loss) in respect of the interest accrued to the time when the interest first became subject to the rules in section 94.2. The expression “deferral amount ” in respect of a participating interest of a taxpayer in

an entity applies principally for the purpose of determining the value of D in the “mark-to-market formula” (as defined in subsection 94.2(1)) for a taxation year of the taxpayer in respect of the participating interest. That formula applies in determining, under subsection 94.2(4), a taxpayer’s income or loss (or capital gain or capital loss) from the participating interest for a taxation year. Subsection 94.2(4) generally provides for the recognition of a deferral amount in respect of a participating interest on the disposition of the interest. Because of paragraph 94.2(2)(a), identical participating interests are considered to be disposed of in the order in which they were acquired.

For a participating interest, in a non-resident entity, acquired after the beginning of the taxpayer’s first taxation year that began after 2002, the deferral amount will be nil in the typical cases where the rules in section 94.2 apply to the interest for the year in which the interests were acquired.

The deferral amount is calculated, in conjunction with subsections 94.2(5) and subsection 128.1(4), so that gains and losses accruing while a taxpayer is not resident in Canada are ignored for the purposes of section 94.2, except in the unusual case where an interest in a FIE is taxable Canadian property.

Additional rules affecting the calculation of the deferral amount are contained in subsections 94.2(6) and (14) to (18), as described in the commentary below.

### **“gross-up factor”**

The definition “gross-up factor” for a particular deferral amount is 1, except where the  $\frac{1}{2}$  factor is relevant in computing the deferral amount because the property is capital property. In the latter case, the “gross-up factor” is 2 (i.e., the reciprocal of the  $\frac{1}{2}$  factor). For more information on the relevance of this definition, see the commentary on subsection 94.2(12).

### **“mark-to-market formula”**

The definition “mark-to-market formula” provides a formula that applies, for a taxation year of a taxpayer in respect of a participating interest of the taxpayer, in determining, under subsection 94.2(4), a taxpayer’s income or loss (or, where subsection 94.2(20) applies in respect of the participating interest, the capital gain or capital loss) from the participating interest for a taxation year.

The amount determined under the formula for a taxpayer's taxation year in respect of a participating interest in a non-resident entity is computed as follows:

- [A] ADD the proceeds of disposition in the year from any disposition by the taxpayer in the year of the interest (other than a disposition arising from the application of subsection 128.1(4) or 149(10), given that the value of B would take into account the fair market value of the interest at the time of such deemed dispositions);
- [B] ADD, where the taxpayer held the interest at the end of the year, the fair market value of the interest at that time (determined before taking into account the FIE's liability in respect of any amount payable from the FIE in respect of the interest);
- [C] ADD the total payments received by the taxpayer in the year from the FIE, other than payments included in the value of A;
- [D] ADD, where the taxpayer so elects for a year during which the taxpayer did not dispose of the interest, any positive deferral amount in respect of the interest;
- [D] ADD, where the taxpayer disposed of the interest in the year and the election referred to above has not been previously made, the deferral amount in respect of the interest - the value of D will reduce the amount determined under the formula in the event that the deferral amount is a negative amount;
- [E] SUBTRACT the cost of the interest on any acquisition in the year of the interest (disregarding acquisitions arising because of the application of subsection 128.1(4) or 149(10), given that these acquisitions are taken into account in the value of F);
- [F] SUBTRACT, where the taxpayer held the interest at the beginning of the year, the fair market value of the interest at the beginning of the year; and
- [G] SUBTRACT, in the case of a foreign insurance policy to which subsection 94.2(3) applies because of the operation of new subsections 94.2(10) and (11), any loss denied for the preceding year because of the operation of clause 94.2(4)(a)(ii)(A).

Ignoring the descriptions of D and G, the mark-to-market formula in effect determines the net increase or decrease in the fair market value of a taxpayer's participating interest in a non-resident entity for a taxation year.

The value of D represents a taxpayer's accrued gain or loss when a participating interest first becomes subject to section 94.2. The amount of this accrued gain or loss (or one half of it, in the event so provided in paragraph (b) of the definition "deferral amount" in subsection 94.2(1)) is included in computing income under the description of D, but only for the taxation year in which the interest is disposed of unless the taxpayer elects for earlier recognition of a positive deferral amount. (An earlier recognition of a positive deferral amount may be beneficial for a taxpayer, particularly where section 94.4 applies.) Where the taxpayer is a trust, a disposition may occur as a consequence of the application of the 21-year deemed disposition rule. See, in this regard, new subsection 104(4.1).

For more detail, see the commentary on subsections 94.2(3) and (4) and the definitions "deferral amount" and "gross-up factor" in subsection 94.2(1).

### **"readily obtainable fair market value"**

The definition "readily obtainable fair market value" is relevant in determining whether a taxpayer may elect to have subsection 94.2(3) (and, as a result, subsection 94.2(4)) apply for a taxation year in respect of a particular participating interest (as defined in subsection 94.1(1)) of the taxpayer in a non-resident entity (as defined in subsection 94.1(1)).

In general terms, the readily obtainable fair market value of a particular participating interest is, if one of two sets of conditions is met, its fair market value.

The first set of conditions requires, in respect of the particular participating interest that:

- participating interests that are identical to the particular participating interest be listed on a prescribed stock exchange throughout the period, in the taxpayer's taxation year that includes that time, during which the taxpayer held the particular participating interest,
- the particular participating interest would, at that time, be an arm's length interest of the taxpayer (determined without regard to the 10%



limitation that normally applies under paragraph (b) of the definition “arm’s length interest” in subsection 94.1(1)),

- there be a regularly published price of the amount (or of the average of the amounts each of which is the amount) at which participating interests that are identical to the particular participating interest last traded on that stock exchange on each of the latest 10 consecutive “trading days” (as defined in subsection 94.2(1)) of the participating interests on that stock exchange, , and
- within the 30-day period that begins before the particular time there are at least 10 trading days of the identical participating interests on that stock exchange,

Note that, under paragraph 94.2(2)(c), where the identical participating interests are listed on more than one prescribed stock exchange, the taxpayer may generally elect which of the exchanges will be used in applying the definition “readily obtainable fair market value”. For more information, see the commentary on paragraph 94.2(2)(c).

Where the first set of conditions is not met, the second set of conditions requires that the identical participating interests have, throughout the period, in the taxpayer’s taxation year that includes that time, during which the taxpayer held the particular participating interest, conditions attached that require the non-resident entity to accept at the demand of the holders of the participating interests (or that require the holders of the participating interests to accept, at the demand of the non-resident entity), at a price (“the redemption price”) determined and payable in accordance with the conditions, the surrender in whole or in part of the participating interests. In addition, the second set of conditions requires that the redemption price be determined by reference to the fair market value, at the time the participating interest is surrendered, of the property of the non-resident entity, and be a price that would have been acceptable to entities dealing at arm's length with one another.

### **“reconciliation amount”**

The reconciliation amount in respect of a participating interest of a taxpayer is relevant in determining what adjustments, if any, to the cost of the interest may be required under subsection 94.2(12) and what amounts, generally, may be included or deductible, under subsection 94.2(21), by the taxpayer in computing the taxpayer’s income for a taxation year in which the interest is disposed of. For more detail, see the commentary on subsections 94.2(12) and (21).

The reconciliation amount at a particular time in a taxation year of a taxpayer in respect of a participating interest of the taxpayer, means, in very general terms the amount (including a negative amount) that is the difference between the taxpayer's economic loss in respect of the interest (while the taxpayer held the interest and subsection 94.2(4) applied to it) and the taxpayer's deductions, in computing income, under sections 94.2 or 94.4 (net of income inclusions under section 94.2)) in respect of the interest.

More specifically, the reconciliation amount at a particular time in a taxation year in respect of a participating interest is the amount (including a negative amount) determined by the formula " $A - B$ ".

Under the formula, " $A$ " is the positive amount (for more detail, see section 257 of the Act) determined by subtracting from the cost of the participating interest to the taxpayer (determined without reference to section 94.2, except paragraph 94.2(2)(a)), the proceeds of disposition from the last disposition in the taxation year by the taxpayer of the participating interest (or, if paragraph 94.2(12)(a) deemed the taxpayer to have acquired the participating interest in the taxation year, the cost to the taxpayer of the participating interest).

Variable " $B$ " is the positive amount determined by

- ADDING all amounts, in respect of the participating interest, that are, in computing the taxpayer's income for a specified year, deducted under paragraph 94.4(2)(a) or deducted, or that would if this Act were read without reference to subsection 94.2(20) have been deducted, under subsection 94.2(4), and
- SUBTRACTING all amounts in respect of the participating interest, that are, in computing the taxpayer's income for a specified year, included, or that would if this Act were read without reference to subsection 94.2(20) have been included, under subsection 94.2(4).

For this purpose, a specified year means, if paragraph 94.2(12)(a) deems the taxpayer to have acquired the participating interest at a time in the taxation year, a preceding taxation year, and in any other case, the taxation year that includes the particular time or a preceding taxation year.

For more detail, see the commentary on subsections 94.2(4), (12) and (21) and 94.4(2).

## “tracking entity”

The definition “tracking entity” is relevant in determining whether subsections 94.1(4) and 94.2(4) will apply for a taxation year of a taxpayer in respect of a participating interest, held by the taxpayer at the end of the year, in a non-resident entity. If the non-resident entity is, at the end of a taxation year of the non-resident entity that ends in the taxpayer’s year, a tracking entity, and the other conditions described in subsection 94.2(9) are met, such that subsection 94.2(9) applies, then either of subsections 94.1(4) or 94.2(4) would generally apply for the year.

A particular non-resident entity is a tracking entity in respect of a particular participating interest of a taxpayer in the non-resident entity if either of paragraph (a) or (b) of the definition applies.

Under paragraph (a) of the definition, the particular non-resident entity is a tracking entity if

- the tracked properties described in paragraph 94.2(9)(d) in respect of the particular participating interest are at that time owned by the particular non-resident entity,
- the total fair market value at that time of those tracked properties is less than 90% of the total fair market value at that time of all property owned at that time by the particular non-resident entity, and
- the total fair market value at that time of those tracked properties that are at that time investment property exceeds 50% of the total fair market value at that time of those tracked properties.

Under paragraph (b) of the definition, the particular non-resident entity will be a tracking entity if

- any of the tracked property described in paragraph 94.2(9)(d) in respect of the participating interest is not at that time owned by the particular non-resident entity,
- the particular non-resident entity (or an entity with which the particular non-resident entity does not deal at arm’s length) owns property that is at that time investment property, and

- it is reasonable to conclude that that investment property (or property that may be substituted for that investment property) may be used, or give rise to property used, to satisfy, directly or indirectly, the right referred to in paragraph 94.2 (9)(d) in respect of the particular participating interest.

Note that an election under paragraph 94.1(2)(j) is relevant only in determining whether an entity is a “foreign investment entity” (and where stipulated, a “qualifying entity”), as those expressions are defined in subsection 94.1(1). Thus the determination of whether property is owned or not by an entity is made, for the purposes of the definition “tracking entity”, without regard to that election.

Note also that the exclusion of “exempt property” from being treated as “investment property” (as those expressions are defined in subsection 94.1(1)) does not apply for the purposes of the definition “tracking entity”.

For more information on the application of this definition, see the commentary on subsections 94.1(4) and 94.2(3) and (9). For more information on paragraph 94.2(1)(j) and the definitions “exempt property” and “investment property” in subsection 94.1(1), see the commentary on those provisions.

### **“trading day”**

The definition “trading day” is relevant in applying paragraph (a) of the definition “readily obtainable fair market value” in subsection 94.2(1). A trading day of a participating interest on a prescribed stock exchange, means a day on which the participating interest trades on that stock exchange.

### **Rules of application**

ITA

94.2(2)

New subsection 94.2(2) of the Act provides rules of application for the purpose of section 94.2.

#### *Identical Properties*

Paragraph 94.2(2)(a) provides that identical properties that were held and are disposed of by a taxpayer will be treated as having been



disposed of in the order in which they were acquired by the taxpayer. For this purpose, paragraph 94.2(2)(a) makes it clear that the various acquisitions that are deemed to occur under the Act (e.g., section 47) are not to be taken into account. This measure is relevant primarily for the purpose of determining the amount to be added or deducted from a taxpayer's income for a taxation year under subsection 94.2(4), especially with reference to the “deferral amount” referred to in the description of D in the “mark-to-market formula” for the year (as those expressions are defined in subsection 94.2(1)).

### *Application*

Paragraph 94.2(2)(b) provides that the rules in subsection 94.1(2) also apply for the purposes of section 94.2.

### *Readily Obtainable Fair Market Value*

Paragraph 94.2(2)(c) applies for the purpose of paragraph (a) of the definition “readily obtainable fair market value” in subsection 94.2(1), referred to in the commentary above, in respect of a particular participating interest in a non-resident entity held by a taxpayer in a taxation year. Where participating interests in the non-resident entity that are identical to the particular participating interest are listed on more than one prescribed stock exchange, the references in that definition to a prescribed stock exchange shall be read as a reference to the prescribed stock exchange in respect of which the taxpayer files an election with the Minister of National Revenue.

If the taxpayer does not so elect or participating interests that are identical to the particular participating interest are no longer listed on the stock exchange identified in the taxpayer's election referred, the references in that definition to a prescribed stock exchange shall be read as a reference to the prescribed stock exchange chosen by the Minister of National Revenue.

### *Restrictions on Application of Mark-to-Market Rules*

Paragraph 94.2(2)(d) provides that the mark-to-market regime in subsection 94.2(4) will not apply to a taxpayer in respect of certain participating interests of the taxpayer. The rule applies if the taxpayer has been subject to subsection 94.2(4) in respect of a participating interest because of an election in respect of the interest where the interest has a readily obtainable fair market value and subsection 94.2(3) ceases to apply. For example, paragraph 94.2(2)(d) would apply

where the interest (other than a foreign insurance policy) ceases to have a readily obtainable fair market value or the Minister fails to receive, in response to a demand under paragraph 94.2(2)(e), information satisfactory to make a determination of whether the interest has a readily obtainable fair market value.

Where paragraph 94.2(2)(d) applies the taxpayer will become subject to 94.1(4) in respect of the participating interest if 94.1(3) continues to apply to the taxpayer in respect of the participating interest.

Note that if, subsection 94.2(4) applies to a taxpayer for a taxation year in respect of a participating interest in a tracking entity and in the immediately following year the interest ceases to be an interest in a tracking entity and becomes subject to subsection 94.1(3), then the taxpayer may elect to have subsection 94.2(4) apply for that immediately following year. In this regard, see the commentary on clause 94.2(3)(b)(ii)(B).

Paragraph 94.2(2)(e) provides that paragraph 94.2(3)(b) does not apply to a taxpayer for a particular taxation year in respect of a participating interest held in the particular taxation year by the taxpayer in a non-resident entity if the Minister sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to determine whether the participating interest has a readily obtainable fair market value and information satisfactory to the Minister to make the determination is not received by the Minister within 60 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand.

### *Characterization of Income from FIE Interest*

Paragraphs 94.2(2)(f) and (g) provide special rules for determining whether a taxpayer's income for a taxation year from the application of subsection 94.2(4) will be treated as income from a source outside Canada. Paragraph 94.2(2)(f) provides that in applying subparagraph 94.2(4)(a)(i) to a taxpayer (that is a trust) for a particular taxation year of the taxpayer and in respect of a participating interest of the taxpayer in a non-resident entity, the reference in that paragraph to "as income from property that is the participating interest" shall be read as a reference to "as income from property that is a source outside Canada that is the participating interest". However, this special rule applies only if the portion of the net accounting income of the non-resident entity, from sources outside Canada, for its last taxation year that ends in the

particular taxation exceeds 90% of the total net accounting income of the non-resident entity for that last taxation year.

Paragraph 94.2(2)(g) provides that in applying subparagraph 94.2(4)(b)(i) to a taxpayer (that is a trust) for a particular taxation year of the taxpayer and in respect of a participating interest of the taxpayer in a non-resident entity, the reference in that paragraph to “a capital gain for the year” shall be read as a reference to “a capital gain for the year from a source outside Canada and”. However, this special rule applies only if the portion of the net accounting income of the non-resident entity, from sources outside Canada, for its last taxation year that ends in the particular taxation year exceeds 90% of the total net accounting income of the non-resident entity for that last taxation year.

The application of paragraphs 94.2(2)(f) and (g) (and a related rule in paragraph 94.1(2)(d)) in respect of a participating interest of a taxpayer will not be relevant in determining a taxpayer’s eligibility for a foreign tax credit under section 126 of the Act. In this regard, see the commentary below on subsections 94.3(2) and 126(1.2). Rather, paragraph 94.2(2)(g) and (h) provide relief to trusts resident in Canada that hold participating interests in a FIE and that make payable to their non-resident beneficiaries all or part of the trusts’ incomes arising under subsection 94.2(4). Where paragraph 94.2(2)(f) or (g) applies and the terms of the trust permit amounts of deemed income of the trust to be made payable to beneficiaries, the amounts of such trust income arising under subsection 94.2(4) that become payable to non-resident beneficiaries of the trust may qualify for reduced withholding if the non-resident beneficiary is resident in a country with which Canada has entered a tax treaty and the tax treaty contains a provision permitting such a reduction in withholding.

Where paragraphs 94.2(2)(f) and (g) do not apply, income and capital gains arising under subsection 94.2(4) are from a source inside Canada.

## **Mark-to-market**

### **ITA**

#### **94.2(3) and (4)**

Subsection 94.2(3) of the Act sets out those circumstances where, subject to paragraphs 94.2(2)(d) and (e) and 94.2(5)(b), subsection 94.2(4) applies to a taxpayer in respect of a participating interest in a non-resident entity. For the mark-to-market regime in subsection



94.2(4) to apply for a taxation year, subsection 94.2(3) must apply for the year.

Except as described above, subsection 94.2(3) will apply to a taxpayer for a particular taxation year in respect of a participating interest, in a non-resident entity, held by the taxpayer in the year (and in respect of any other participating interests in the non-resident entity that are identical to the participating interest and that are held by the taxpayer in the year) if either:

- Paragraph 94.2(11)(a) (foreign insurance policies) applies to the taxpayer for the year in respect of the interest; or
- Subsection 94.1(3) or 94.2(9) (interests in tracking entities) applies to the taxpayer in respect of the interest, the interest has at all times in the year at which the taxpayer held it a readily obtainable fair market value (as defined in subsection 94.2(1)) and the taxpayer elects, generally in the taxation year of the taxpayer in which the taxpayer is first subject to subsection 94.1(3) or 94.2(9) in respect of the participating interest or an identical interest, to have subsection 94.3(3) apply.

Note that under clause 94.2(3)(b)(iii)(B) a taxpayer may elect, to have subsection 94.3(3) apply, in a year other than the first taxation year in which subsection 94.1(3) or 94.2(9) applies to the taxpayer in respect of the participating interest or an identical interest if the election is made in the taxpayer's return of income for a taxation year in which subsection 94.1(3) applies and that taxation year immediately follows a taxation year for which the interest is subject to subsection 94.2(9) (i.e., an interest of the taxpayer in a tracking entity).

Where subsection 94.2(3) applies (and subsection 94.2(20) does not apply) to a taxpayer's participating interest in a non-resident entity, subparagraph 94.2(4)(a)(i) requires the taxpayer to include in computing income as income from property (in this regard, see the commentary on paragraph 94.2(2)(f)) from a property that is the participating interest the positive amount resulting from the operation of the mark-to-market formula for the taxation year in respect of the participating interest. Under subparagraph 94.2(4)(a)(ii), the absolute value of any negative amount resulting from the operation of the same formula may be deducted in computing the taxpayer's income as a loss from property from a property that is the participating interest. (Note, however, that losses in respect of foreign insurance policies are denied



because of clause 94.2(4)(a)(ii)(A). Instead, as described in the commentary to the definition “mark-to-market formula” in subsection 94.2(1), the denied losses are carried forward to offset later income inclusions.)

Where both subsections 94.2(3) and 94.2(20) apply to a taxpayer’s participating interest in a non-resident entity, subparagraph 94.2(4)(b)(i) deems the taxpayer to have a capital gain for the year from the disposition of capital property (in this regard, see the commentary on paragraph 94.2(2)(g)), that is the participating interest, in the taxation year equal to the positive amount determined under the mark-to-market formula for the taxation year in respect of the participating interest plus or minus the positive or negative deferral amount included in “D” in that same formula in respect of the participating interest for the year. Subparagraph 94.2(4)(b)(ii) deems the taxpayer to have capital losses in the year equal to the negative amount determined under the market formula for the taxation year in respect of the participating interest plus or minus the negative or positive deferral amount included in “D” in that same formula in respect of the participating interest for the year.

The example below illustrates the operation of subsection 94.2(4) and the mark-to-market formula for a taxation year in respect of a participating interest.

### *Example*

1. *Leonard acquires a 1% interest in ABC Inc. in 1999 for \$500. On December 31, 2000, it is capital property to Leonard. ABC Inc. is not a FIE in respect of the taxpayer at any time before 2004. Subsection 94.2(20) does not apply at any time in respect of the interest.*
2. *ABC Inc. becomes a FIE during 2004 and Leonard elects under subparagraph 94.2(3)(b)(iii) to have the rules in section 94.2 apply. Leonard's interest in ABC Inc. does not qualify as an “exempt interest”.*
3. *The fair market values of Leonard's participating interest at the beginning and at the end of 2004 are \$800 and \$1,000 respectively.*
4. *Leonard disposes of his shares just before the end of 2005 for \$1,200. ABC Inc. does not make any distributions to Leonard during his period of ownership.*

*Results*

1. *No amount is included in Leonard's income for 2003 under any of sections 94.1 to 94.3. For 2004, Leonard is required to include \$200 in income under subparagraph 94.2(4)(a)(i).*
2. *The \$200 inclusion is determined under the mark-to-market formula and subparagraph 94.2(4)(a)(i) as follows:*
  - *"A" is nil, since no participating interest in ABC Inc. is disposed of in 2004,*
  - *"B" is \$1,000, the fair market value of the participating interest at the end of 2004,*
  - *"C" is nil since no payments are received in 2004,*
  - *"D" is nil since no participating interest is disposed of in 2004 and no election was otherwise made,*
  - *"E" is nil since no participating interest in ABC Inc. is acquired in 2004, and*
  - *"F" is \$800, the fair market value of the participating interest at the beginning of 2004.*
3. *Although Leonard's participating interest has appreciated by \$500 since the time of its acquisition, only \$200 is required to be included in income under section 94.2 for 2004.*
4. *For 2005, the amount included in income under the mark-to-market formula and subparagraph 94.2(4)(a)(i) is \$350, computed as follows:*
  - *"A" is \$1,200, the proceeds of disposition of the participating interest,*
  - *"B" is nil since Leonard does not own any participating interest in ABC Inc. at the end of 2005,*
  - *"C" is nil since no payments or distributions were received in 2005,*

- “D” is \$150, the deferral amount in respect of the interest – the “deferral amount” is one half (the one-half factor applies because Leonard's interest in ABC Inc. is capital property held by Leonard on June 22nd 2000) of the amount by which \$800 (the fair market value of the interest at the beginning of 2004 which is the first year in respect of which section 94.2 applies to the interest) exceeds \$500 (the cost amount of the interest),
- “E” is nil since no participating interest in ABC Inc. is acquired in 2005, and
- “F” is \$1,000, the fair market value of the participating interest at the beginning of 2005.

### **Non-resident Periods Excluded**

ITA

94.2(5)

New subsection 94.2(5) of the Act provides special rules dealing with the application of section 94.2 for a taxation year to persons who are not resident in Canada throughout the year.

Under paragraph 94.2(5)(a), the amounts determined under section 94.2 are generally determined as if the taxation year of the taxpayer excludes the period in the year during which the taxpayer is not resident in Canada. This rule, in conjunction with section 128.1, generally ensures that the increases and decreases in fair market values that are relevant in determining income inclusions and deductions under section 94.2 are the increases and decreases occurring while the taxpayer is resident in Canada. However, this rule does not affect the calculation of the taxpayer's deferral amount: paragraph (b) of the definition “deferral amount” in subsection 94.2(1) (in conjunction with subsection 128.1(1)) already ensures that gains or losses accruing prior to becoming resident in Canada are not taken into account for the purposes of computing a taxpayer's deferral amount in respect of a participating interest in a FIE, except in the unusual case where the FIE interest is taxable Canadian property.

Paragraph 94.2(5)(a) also ensures that subsection 94.2(4) does not apply to a taxpayer for a taxation year throughout which the taxpayer is not resident in Canada.

Under paragraph 94.2(5)(b), subsection 94.2(3) generally does not apply to a taxpayer at a particular time if the taxpayer is not resident in Canada at the particular time. This has relevance for the purposes of a number of new provisions, including subparagraph 39(1)(a)(ii.3). This subparagraph has the effect of excluding, from a taxpayer's capital property, a property in respect of which subsection 94.2(3) applies and is intended to ensure that there is no double taxation with respect to the same economic gain. Paragraph 94.2(5)(b) thus ensures that a non-resident taxpayer cannot claim that a taxable Canadian property consisting of a FIE interest is not capital property on the basis of subparagraph 39(1)(a)(ii.3). (Note: non-resident taxpayers are generally subject to tax on taxable capital gains from their dispositions of taxable Canadian properties.)

Paragraph 94.2(5)(c) applies in the unusual case where an individual changes his or her Canadian residence status more than once in the same calendar year. For example, an individual might leave Canada near the beginning of a calendar year but return later in the same year. In the event that such an individual is considered not to reside in Canada during a period in the calendar year, the individual's period of non-residence would be included within the individual's taxation year and the rule in paragraph 94.2(5)(a) would have no effect. In order to not tax gains accrued while an individual was non-resident and to not provide relief for losses accrued during the same period, paragraph 94.2(5)(c) provides that:

- for the purposes of section 114, the individual's income or loss from the individual's period of non-residence is determined without reference to section 94.2, and
- in computing the individual's taxable income under section 114,
  - there is to be deducted the increase in the fair market value of an interest in a FIE to which subsection 94.2(4) applies during the non-resident period (this fair market value appreciation would be reflected in the amount determined under the mark-to-market formula (as defined in subsection 94.1(1)) in respect of the interest in computing the taxpayer's income), and
  - there is to be added the decline in the fair market value of an interest in a FIE to which subsection 94.2(4) applies that accrued during the non-resident period (this fair market value decline would be reflected in the amount determined under the mark-to-



market formula in respect of the interest in computing the taxpayer's income).

The example below illustrates the operation of paragraph 94.2(5)(c).

### **Example**

*Bernard emigrates from Canada on February 1, 2003 in order to start permanent employment elsewhere. Due to unexpected changes in circumstances, he returns to Canada on December 1, 2003. Bernard owns an interest in a FIE to which section 94.2 applies. The fair market value of the interest in 2003 increases from \$100 (January 1, 2003), to \$105 (February 1, 2003), to \$108 (December 1, 2003) and to \$107 (December 31, 2003). It is assumed that Bernard establishes that he did not reside in Canada from February 1, 2003 to December 1, 2003.*

### **Results**

1. Under section 94.2(4), the amount included in computing Bernard's income for 2003 is equal to \$7 ( $B = 107$ ,  $F = 100$ ).
2. Paragraph 94.2(5)(c) permits a deduction for the purposes of paragraph 114(a) equal to \$3 (i.e.,  $\$108 - \$105$ ) equal to the appreciation in the fair market value of the interest while Bernard was not resident in Canada. As a consequence, Bernard's taxable income in respect of the FIE interest for 2003 is \$4 (i.e., \$7 minus \$3).

## **Foreign Partnerships – Change of Residence of Member**

### **ITA**

#### **94.2(6) to (8)**

New subsections 94.2(6) to (8) of the Act provide special rules for partnerships having non-resident members. These subsections are analogous to rules in existing subsections 96(8) and (9) and are designed, in general terms, to prevent partnership losses that accrue while no partnership member is resident in Canada from being used in Canada. A further rule for partnership members is set out in new subsection 96(1.9).

More specifically, subsection 94.2(6) applies where a partnership begins to have members who reside in Canada. Under subsection 94.2(7), a

corresponding rule applies in a similar fashion where a partnership ceases to have members who reside in Canada. In either case, for the purposes of determining amounts under section 94.2 portions of the fiscal period of the partnership in which no member is resident in Canada will generally be disregarded.

Where subsection 94.2(6) applies to a partnership at any time, the deferral amount for a FIE interest held by the partnership immediately before that time is computed with reference to the fair market value and the cost amount of the interest. However, if a negative deferral amount is otherwise determined with respect to the interest, the deferral amount is deemed to be nil.

As a consequence of subsections 94.2(6) and (7), amounts added or deductible under subsection 94.2(4) for a partnership in respect of a FIE interest will generally reflect increases or decreases in fair market value while the partnership has members resident in Canada. However, once the interest is disposed of, an amount reflecting gains accruing before any member became resident in Canada will be recognized because of the application of subsection 94.2(4).

Subsection 94.2(8) contains an anti-avoidance rule, which is aimed at preventing the insertion of nominal Canadian resident partners for tax planning purposes. This rule is parallel to the rule in existing subsection 96(9).

Subsection 94.2(8) also contains a “look-through” rule. It allows for the “look-through” of one or more tiers of partnerships for the purposes of determining whether a person is a member of a partnership.

### **Participating Interests in a Tracking Entity**

ITA

94.2(9)

New subsection 94.2(9) of the Act is an anti-avoidance rule intended to prevent the circumvention of subsection 94.1(3) through the use of a participating interest, in a “tracking entity” (as defined in subsection 94.1(1)). Where subsection 94.2(9) applies with regard to an interest in a tracking entity for a taxation year, subsection 94.1(4) will apply to the taxpayer for that year unless subsection 94.2(3) applies for that year in respect of the interest.

Subsection 94.2(9) applies to a taxpayer (other than an exempt taxpayer, as defined in subsection 94.1(1)) for a particular taxation year of the taxpayer in respect of a particular participating interest of the taxpayer in a non-resident entity (and any participating interests of the taxpayer in the non-resident entity that are identical to the particular participating interest) if

- subsection 94.1(3) does not apply to the taxpayer for the particular taxation year in respect of the particular participating interest,
- the particular participating interest is, at the end of a taxation year of the non-resident entity that ends in the particular taxation year, held by the taxpayer, and generally not an “exempt interest” (as defined in subsection 94.1(1)); however, note that an interest of a taxpayer in a controlled foreign affiliate of the taxpayer or a “qualifying entity” (as defined in subsection 94.1(1)) will not qualify as an exempt interest for this purpose, with the result that subsection 94.2(9) may apply to such interests,
- the non-resident entity is, at the end of that taxation year of the non-resident entity, a “tracking entity” (as defined in subsection 94.2(1)) in respect of the particular participating interest,
- at any time in the particular taxation year, the amount of any payment (under a right to receive, in any manner whatever and from any entity, amounts in respect of the particular participating interest or any identical interests), or the value of such a right, is, directly or indirectly, determined primarily by one or more of the following criteria in respect of one or more properties (such property or properties together referred to in subsection 94.2(9) and the definition “tracking entity” in subsection 94.2(1) as “tracked property” or “tracked properties”):
  - production from the property, use of the property, gains from the disposition of the property, profits from the disposition of the property, fair market value of the property,
  - income from the property, profits from the property, revenue from the property, cash flow from the property, or
  - any other criterion similar to any of the above criteria and

- throughout each taxation year of the non-resident entity that ends in the particular taxation year, all or substantially all of the fair market value of the tracked property cannot be attributed, either directly or indirectly, to the fair market value of property:
  - that is a share or shares of the capital stock of a corporation that is at that time a particular foreign affiliate of the taxpayer that if held at that time by the taxpayer would be a qualifying interest (within the meaning assigned by paragraph 95(2)(m)) of the taxpayer in the particular foreign affiliate of the taxpayer, and a participating interest of the taxpayer in a qualifying entity, and
  - that is not at that time tracked property in respect of a participating interest in a non-resident entity of an entity that is not related to the taxpayer.

It should be noted that tracked properties can include any property, whether owned by the non-resident entity or not. For example, if the fair market value of shares issued by a non-resident entity were tracked to the worldwide price of gold bullion, the tracked properties in question would be the worldwide supply of gold bullion. Whether subsection 94.2(9) applies in this case or not would typically depend on whether the non-resident entity is a tracking entity, as defined in subsection 94.2(1).

## **Treatment of Foreign Insurance Policies**

### **ITA**

#### **94.2(10) and (11)**

New subsection 94.2(10) of the Act applies if a taxpayer (other than an exempt taxpayer, as defined in subsection 94.1(1)) holds, at any time in a particular taxation year of the taxpayer, an interest in a foreign insurance policy. For this purpose, a foreign insurance policy is one that is not issued by an insurer in the course of carrying on business in Canada the income from which is subject to tax under Part I.

Subsection 94.2(11) sets out the treatment under section 94.2 of an interest in the foreign insurance policy. Where subsection 94.2(10) applies, paragraph 94.2(11)(a) provides, subject to paragraph 94.2(11)(c), that



- it applies to the interest, with the result that, in conjunction with paragraph 94.2(3)(a), the mark-to-market rules in subsection 94.2(4) apply to the interest, and
- no amount shall be included or deducted, as the case may be, under section 12.2, paragraphs 56(1)(d) and (j) and 60(a) and (s) and sections 138.1 and 148 in respect of the interest for the purpose of computing the taxpayer's income for the particular taxation year.

Paragraph 94.2(11) (b) generally provides that, where a taxpayer (other than an exempt taxpayer) holds an interest in a foreign insurance policy, for the purposes of subsections 94.2(1) to (4) (and a corresponding foreign property reporting rule in subsection 233.3(1)) the particular interest is deemed to be a participating interest in a non-resident entity. However, the mark-to-market regime under subsection 94.2(4) applies differently to insurance policies in three respects:

- first, no deferral amount is calculated with regard to insurance policies,
- second, losses are not deductible, but instead can be used to offset future income amounts otherwise arising under subsection 94.2(4). (As to the treatment of losses, see the commentary on the definition “mark-to-market formula” in subsection 94.2(1)), and
- third, the interest will not be a participating interest for the purposes of subsection 94.2(20), so that paragraph 94.4(2)(b) will not apply to amounts determined under the mark-to-market formula in respect of the interest.

Paragraph 94.2(11)(c) provides that paragraphs 94.2(11)(a) and (b) do not apply to a taxpayer in respect of an insurance policy in the following situations:

- The taxpayer is an individual and the interest in the policy was acquired more than five years before the taxpayer became resident in Canada. However, this exception does not apply if premiums in excess of the level originally contemplated under the policy have been paid within 5 years of the policyholder becoming resident in Canada or while the policyholder was resident in Canada.
- Under the terms and conditions of the policy, the policyholder is entitled to receive only benefits payable as a consequence of the

occurrence of the risks insured under the policy, an experience rated refund of premiums for a year and a return of premiums previously paid upon the surrender, cancellation or termination of the policy.

- The taxpayer can establish to the satisfaction of the Minister of National Revenue that
  - the interest in the policy was, on the anniversary day (as defined in subsection 12.2(11)) of the policy that occurs in the taxation year, an exempt policy, or
  - an appropriate amount of income has been included in the taxpayer's income under section 12.2 in respect of the policy or that the interest in the policy is an interest in an exempt policy for the purpose of that section.

In the event that new paragraphs 94.2(11)(a) and (b) do not apply to a taxpayer in respect of an interest in an insurance policy in a particular year but apply to that taxpayer in respect of that interest in the following year, paragraph 94.2(11)(d) provides that the taxpayer is deemed to have acquired the interest in the insurance policy, at its fair market value at the end of the particular year (determined with reference to paragraph 94.2(11)(f)), immediately after the beginning of the following taxation year.

In the event that paragraphs 94.2(11)(a) and (b) do not apply to a taxpayer in respect of an interest in an insurance policy for a taxation year but did apply in the preceding taxation year, paragraph 94.2(11)(e) provides that the taxpayer is deemed to have disposed of the interest in the insurance policy immediately before the end of the preceding taxation year for proceeds equal to its fair market value at that time.

Paragraph 94.2(11)(f) provides that the fair market value of an interest in an insurance policy and amounts of proceeds of disposition of an interest in an insurance policy and payments in respect of interests in insurance policy are determined without reference to benefits paid, payable or anticipated to be payable under the policy only as a consequence of the occurrence of the risks insured under the policy.

Paragraph 94.2(11)(g) provides that, where a taxpayer makes a premium or a policy loan payment in respect of an insurance policy in a taxation year, an interest in the insurance policy is deemed to have been acquired in the year. The cost of the interest is the total of the premiums paid, the

payments of the principal amount of policy loans to the extent the loans were included in proceeds of disposition of the interest in prior years, and any amount paid by the taxpayer to acquire the interest from an entity other than the insurer that issued the policy.

Paragraph 94.2(11)(h) provides rules permitting additions to the deemed cost of an interest in a policy otherwise determined for a year where the actual costs exceed the fair market value of interest at the beginning of the first taxation year in which subsection 94.2(4) applies to the taxpayer in respect of these interests. The amount that may be added is the amount, if any, by which the qualifying premiums paid at or before that time in respect of the interest in the policy exceeds the fair market value of the interest at that time.

Paragraph 94.2(11)(i) provides rules adding to a taxpayer's proceeds of disposition otherwise determined of an interest in an insurance policy for the year in which it is disposed of, the amount by which the fair market value of the interest at the beginning of the first taxation year in which subsection 94.2(4) applies to the taxpayer in respect of the interest exceeds the cost of the interest at that time.

In the event that paragraphs 94.2(11)(a) and (b) do not apply to a taxpayer in respect of an interest in an insurance policy for one taxation year and did apply in the preceding year, paragraph 94.2(11)(j) deems the taxpayer to have acquired the interest at the beginning of the taxation year and provides that the cost of the interest is equal to the amount if any by which the total of the fair market value and the amount that would be determined under subparagraph 94.2(4)(a)(ii) (read without reference to its clause (A)) in respect of the interest at the end of the preceding taxation year exceeds the amount determined under paragraph 94.2(11)(i) in respect of the interest in respect of the taxpayer.

Subsections 94.2(10) and (11) apply for taxation years that begin after 2002.

### ***Example***

*Assume that David, a long-term resident of Canada, pays premiums of \$10,000 to an offshore insurer for a life insurance policy in 2000. The policy's fair market value is \$9,000 and \$10,700 at the end of 2003 and 2004 (respectively).*

## Results

1. *For 2003, no income amount is determined under paragraph 94.2(4)(a) because the cost of the policy exceeds the fair market value at the end of 2003. The cost to David of the policy is deemed to be \$10,000 (\$9000 + \$1000).*
2. *The loss for the year 2003 is \$1000. (\$9000 – \$10,000). No claim in respect of the loss is permitted under paragraph 94.2(4)(b) of the Act. The amount of the denied loss is equal to \$1,000 and is included under G in the formula in paragraph 94.2(4)(a) in year 2004.*
3. *For 2004, the amount included in income under paragraph 94.2(4)(a) is \$700 (= \$10,700 (“B”), minus \$9,000 (“F”), minus \$1,000 (“G”).*

*It is possible that the cash surrender value of a policy may be less than its fair market value.*

## Change of Status

### ITA

#### 94.2(12)

New subsection 94.2(12) of the Act sets out rules that apply where a taxpayer holds a participating interest in a non-resident entity at a time that is the beginning of a particular taxation year and subsection 94.2(4) applied for the purpose of computing the taxpayer's income for the preceding taxation year in respect of the participating interest, but does not apply for the particular taxation year (otherwise than because the taxpayer ceased to reside in Canada or became an exempt taxpayer as defined in subsection 94.1(1)).

Where subsection 94.2(12) applies, the taxpayer is deemed to have acquired the particular interest at the beginning of the following taxation year at a cost equal to the fair market value of the particular interest at that time.

This subsection could apply, for example, where a taxpayer's interest in a foreign investment entity ceases to have a readily obtainable fair market value (as defined in subsection 94.2(1)) or where the entity ceases to be a foreign investment entity (as defined in subsection 94.1(1)).



Since the taxpayer is deemed to have acquired the property at its fair market value at the beginning of the following year, all increases and decreases in the value of the interest from the time of its acquisition are reflected in the taxpayer's cost of the interest for tax purposes. However, only the gain or loss accruing while it was subject to subsection 94.2(4) has been brought into income. Because of the rules in respect of deferral amounts, the gain or loss in value for the period from the time of acquisition to the time it became subject to subsection 94.2(4) would not generally have been taken into consideration for tax purposes.

Accordingly, paragraph 94.2(12)(b) provides for a negative or positive adjustment to the adjusted cost base (ACB) of a participating interest held as capital property. Any positive “deferral amount” (as defined in subsection 94.2(1)) in respect of the interest is deducted in computing the ACB of the interest, but the deduction is grossed-up by a factor of two in the event that the deferral amount was calculated with reference to one-half of the accrued gains. The ACB deduction does not, however, apply in the event that a positive deferral amount has already been taken into account because of an election under the description of D in the mark-to-market formula (as defined in subsection 94.2(1)) for the taxation year in respect of the participating interest. The ACB is also reduced by the amount of any negative “reconciliation amount” (as defined in subsection 94.2(1)) in respect of the participating interest.

The absolute value of any negative deferral amount (or twice the amount if the  $1/2$  factor was used in computing the negative deferral amount) is added in computing the ACB of the interest. There is also added any positive reconciliation amount in respect of the participating interest.

Where capital property is not involved, a corresponding decrease or increase in cost (rather than adjusted cost basis) is provided under paragraph 94.2(12)(c). To the extent that the decrease in respect of the positive or negative deferral amount would otherwise result in a negative cost, the decrease is brought into the taxpayer's income under subparagraph 94.2(12)(c)(ii).

For more detail, see the commentary on paragraphs 53(1)(m.1) and 53(2)(w), the definitions “deferral amount”, “mark-to-market formula” and “reconciliation amount” in subsection 94.2(1), and subsection 94.2(4).

## **Cost of Participating Interest**

ITA

94.2(13)

New subsection 94.2(13) of the Act provides a rule for determining the cost at a particular time of a participating interest in an entity for a taxation year in the event that the interest is disposed of by the taxpayer in the year.

The cost to the taxpayer immediately before the disposition of the property is deemed to be its fair market value at the beginning of the taxpayer's taxation year. In the event that the property was not held by the taxpayer at that time, its cost immediately before the disposition is its cost determined without reference to section 94.2 (other than subsection 94.2(2)). In identifying property for these purposes, identical properties of a taxpayer are considered to be disposed of on a "first in, first out" basis, as a consequence of the application of paragraph 94.2(2)(a).

Under new paragraph (c.2) of the definition "cost amount" in subsection 248(1), the cost determined at a particular time for a property under subsection 94.2 (13) is also the "cost amount" of the property at the particular time.

## **Deferral Amount where Same Interest Reacquired**

ITA

94.2(14)

New subsection 94.2(14) of the Act generally provides that a "deferral amount" in respect of a property of a taxpayer is deemed to be nil, after the property has been disposed of by the taxpayer at a time when the mark-to-market rules in subsection 94.2(4) applied to the property. This is of relevance to property that is reacquired by a taxpayer. However, subsection 94.2(14) is subject to the rules in subsections 94.2(15) to (18).

It should be noted that identical properties of a taxpayer are considered to be disposed of on a "first in, first out" basis as a consequence of the application of paragraph 94.2(2)(a).

## **Fresh-start re Change of Status of Entity**

ITA

94.2(15)

New subsection 94.2(15) of the Act applies where a taxpayer's participating interest in an entity was initially subject to the rules in subsection 94.2(4) and ceases to be subject to those rules (otherwise than because of the taxpayer having become an "exempt taxpayer"). For example, subsection 94.2(15) could apply where an entity ceases to be a FIE.

In these circumstances, the deferral amount in respect of the participating interest is determined without reference to previous applications of subsections 94.2(4) and (14). This rule is relevant only in the event that the same participating interest of the taxpayer again becomes subject to the rules in subsection 94.2(4).

Parallel "fresh-start" rules are contained in subsection 94.2(16) and (17). All of these "fresh-start" rules are expected to be only rarely involved, given that more than one change in status of an investment or a taxpayer is required for the rules to become relevant. For more information on the "deferral amount" defined in subsection 94.2(1), see the commentary on that definition.

## **Fresh-start after Emigration of Taxpayer**

ITA

94.2(16)

New subsection 94.2(16) of the Act affects the calculation of the "deferral amount" in respect of a participating interest in an entity for a taxpayer who has ceased to reside in Canada. It is relevant in the event that, at a subsequent time, the taxpayer becomes resident in Canada again.

In these circumstances, the deferral amounts in respect of the taxpayer's FIE interests are determined without reference to the previous application of subsections 94.2(4) and (14).

For further detail, see the commentary on the related fresh-start rule in subsection 94.2(15).

## **Fresh-start re Change of Status of Tax-exempt Entity**

ITA

94.2(17)

New subsection 94.2(17) of the Act affects the calculation of the “deferral amount” in respect of an interest in an entity for a taxpayer that initially was not an “exempt taxpayer” under paragraph (a) or (b) of that definition in subsection 94.1(1) and then subsequently obtains that status.

In these circumstances, the deferral amounts in respect of the FIE interests of the taxpayer are determined without reference to previous applications of subsections 94.2(4) and (14).

For further context, see the commentary on the related fresh-start rule in subsection 94.2(15). In addition, it should be noted that amended subsection 149(10) applies to changes of tax-exempt status for taxpayers that are corporations. Where subsection 149(10) applies, the rules in subsection 94.2(17) do not apply.

## **Superficial Dispositions**

ITA

94.2(18)

New subsection 94.2(18) of the Act applies where a taxpayer disposes of a participating interest in an entity in respect of which a negative amount is determined under the description of D in the formula in subsection 94.2(4). This would be the case where there is a negative deferral amount associated with the interest. In these circumstances, the deferral amount is instead generally deemed to be nil if, during the period beginning 30 days before the disposition and ending 30 days after the disposition, identical property is acquired by the taxpayer or certain related persons.

Subsection 94.2(18) operates in a manner similar to the “superficial loss” rules for capital properties and is intended to prevent the premature realization of losses in respect of a property in which a taxpayer effectively retains an economic interest. “Superficial loss” has the same meaning as assigned in section 54, except that the definition for the purposes of subsection 94.2(18) does not contain the exception for transactions covered by subsection 40(3.4).



Property substituted for the particular property is, in these circumstances, considered to have the deferral amount associated with the property disposed of.

### **Determination of Capital Dividend Account**

ITA

94.2(19)

New subsection 94.2(19) provides rules that deem a positive or negative deferral amount in respect of a disposition of what would, but for section 94.2, be a capital property of a taxpayer that is a corporation resident in Canada, to be a taxable capital gain or an allowable capital loss, as the case may be, and twice such an amount to be a capital gain or capital loss of the corporation, as the case may be, for the purposes of computing the capital dividend account of the corporation. This rule ensures that 1/2 of a capital gain or a capital loss that is attributable to a deferral amount is reflected in the capital dividend account of a corporation.

### **Application of Paragraph 94.3(4)(b)**

ITA

94.2(20)

New subsection 94.2(20) of the Act provides a special rule that requires a taxpayer to report, as capital gains or losses under paragraph 94.2(4)(b) rather than as income or losses from property under paragraph 94.2(4)(a), amounts determined under the “mark-to-market formula” for a particular year in respect of a participating interest of the taxpayer in a non-resident entity.

This rule applies where two conditions are met. The first condition is that the participating interest of the taxpayer would, if the Act were read without reference to section 94.2, be a capital property of the taxpayer at the last time in the particular taxation year at which the taxpayer held the participating interest.

The second condition is that all or substantially all of the amount required to be added or deducted under the mark-to-market formula for the taxation year in respect of the participating interest, in a particular non-resident entity, can be attributed to

- capital gains or capital losses from the disposition of capital property (other than a participating interest in a foreign investment entity) by the particular non-resident entity or by any foreign investment entity in which the particular non-resident entity has a direct or indirect interest, and
- increases or decreases in the fair market value of capital property (other than a participating interest in a foreign investment entity) of the particular non-resident entity or of any foreign investment entity in which the particular non-resident entity has a direct or indirect interest.

In the event that any entity in a chain or tier of entities holds capital properties that are particular participating interests in foreign investment entities, changes in value of the particular participating interests and gains or losses from the disposition of those interests are ignored in applying the “all or substantially all” requirement. Instead, the requirement would be computed with regard to gains or losses from the disposition of, or changes in value in, capital properties of the foreign investment entities. This is intended to prevent the use of intermediary entities, contrary to the intent of subsection 94.2(20), as a means of triggering the application of paragraph 94.2(4)(b).

## **Reconciliation**

ITA

94.2(21)

New subsection 94.2(21) applies where a taxpayer disposes of an interest in a non-resident entity at a particular time in a particular taxation year. If subsection 94.2(4) applies for the purpose of computing the taxpayer's income for the particular taxation year in respect of the participating interest, in computing that income the taxpayer may be required to include an amount of income (or to have capital gains) or may be permitted to deduct as a loss (or to have capital losses) determined with regard to the reconciliation amount (as defined in subsection 94.1(1)) at that time in respect of the participating interest.

More specifically, under paragraph 94.2(21)(a), where paragraph 94.2(4)(a) applies for the particular taxation year, and subsection 94.2(20) has never applied for a preceding taxation year, in respect of the participating interest,

- there may be deducted, as a loss from property from a property that is the participating interest, the positive reconciliation amount, if any, at that time in respect of the participating interest, and
- there shall be included, as income from property from a property that is the participating interest, the absolute value of the negative reconciliation amount, if any, at that time in respect of the participating interest.

In any other case where subsection 94.2(4) applies for the purpose of computing the taxpayer's income for the particular taxation year in respect of the participating interest, paragraph 94.2(21)(b) provides that

- the taxpayer is deemed to have a capital loss for the taxation year from the disposition in the taxation year of capital property that is the participating interest equal to the positive reconciliation amount, if any, in respect of the participating interest, and
- the taxpayer is deemed to have a capital gain for the taxation year from the disposition in the taxation year of capital property that is the participating interest equal to the absolute value of the negative reconciliation amount, if any, in respect of the participating interest.

Where a taxpayer disposes of a participating interest in a taxation year of the taxpayer and subsection 94.2(21) does not apply (i.e., because subsection 94.2(4) does not apply for the purpose of computing the taxpayer's income for the particular taxation year in respect of the participating interest), subsection 94.2(12) may apply to adjust, with reference to the reconciliation amount in respect of the interest, the taxpayer's adjusted cost base (or cost) of the interest.

For more detail, see the commentary on subsection 94.2(12) and the definition "reconciliation amount" in subsection 94.2(1).

## **Foreign Investment Entities – Accrual**

### **ITA 94.3**

New section 94.3 of the Act sets out new rules for the taxation of interests in FIEs where subsections 94.1(4) and 94.2(3) do not apply.

Section 94.3 applies to taxation years that begin after 2002.

## Definitions

### ITA

#### 94.3(1)

New subsection 94.3(1) of the Act sets out a number of definitions and provides that those definitions and the definitions in subsections 94.1(1) and 94.2(1) apply for the purposes of section 94.2.

#### **“fresh-start year”**

The definition “fresh-start year” is relevant to calculating a taxpayer's “income allocation” (as defined in subsection 94.3(1)) in respect of a FIE. In general terms, a fresh-start year of an entity in respect of a taxpayer that holds a participating interest in the entity means a taxation year of the entity at the end of which it becomes an entity in respect of which subsection 94.1(3) may apply to the taxpayer in respect of the participating interest.

For more detail, see the commentary on subsection 94.3(4) and on the definition “income allocation” in subsection 94.3(1).

#### **“income allocation”**

The definition “income allocation” applies in determining the amount to be included, under “A” of the formula in subsection 94.3(4), in computing a taxpayer's income or loss for the taxpayer's taxation year in respect of a property that is a participating interest of the taxpayer in a FIE.

A taxpayer's income allocation (in respect of a participating interest in a FIE held by the taxpayer at the end of a particular taxation year of the FIE that ends in a taxation year of the taxpayer) is determined by the formula set out in that definition. In general terms, the taxpayer's income allocation is the proportion of the FIE's income for the particular taxation year (“A” in the formula) that the fair market value of the interest (“B” in the formula) is of the fair market value of all participating interests in the FIE (“C” in the formula). (Note that subsection 94.3(4) is unavailable in respect of a particular interest that would not be a participating interest if the definition “participating interest” in subsection 94.1(1) were read without reference to its paragraph (d).)



The calculation of a taxpayer's income allocation in respect of a FIE depends on a calculation of income for the FIE in accordance with rules set out in paragraphs (a) to (l) of "A" in the formula. This permits taxpayers to make independent calculations of a FIE's income for the purpose of determining income allocations under section 94.3 for the FIE's fresh-start year (as defined in subsection 94.3(1)) in respect of the taxpayer and subsequent years.

The special rules that apply in calculating a FIE's income in respect of a taxpayer that is a participating interest holder for the FIE's fresh-start year and subsequent years are as follows:

(a) Subject to three exceptions, the FIE is generally treated as having been a taxpayer resident of Canada throughout its existence. First, this rule does not apply for the purposes of subsection 107.4(1) or paragraph (f) of the definition "disposition" in subsection 248(1), with the result that property that is transferred to the FIE without there being any change in the beneficial ownership of the property is considered to have been transferred to the FIE under subsection 69(1) at its fair market value. Second, this rule does not apply for the purpose of section 91 with the result that the FIE will not itself be required to include an amount in respect of foreign accrual property income in computing the FIE's income. Third, this rule does not apply for the purpose of subparagraph 94.3(2)(b)(ii) with the result that section 94.1 or 94.2 (rather than section 94.3) potentially applies in the event that the FIE owns a participating interest in another FIE.

(b) Each property held by the FIE at the beginning of the fresh-start year is deemed to have been disposed of for its fair market value immediately before that time and reacquired for the same amount at that time.

(c) Each discretionary deduction permitted in computing the FIE's income for the FIE's fresh-start year and subsequent taxation years is deemed to have been claimed to the extent designated by the investor taxpayer. Thus, in calculating an income allocation in respect of the FIE, the investor taxpayer will be permitted to claim deductions such as capital cost allowance.

(d) The FIE is assumed to have deducted the greatest amounts permissible, for its taxation year preceding the fresh-start year, under sections 20, 138 and 140. These amounts are added in computing the FIE's income for the fresh-start year, but

appropriate deductions under these sections can be claimed for the fresh-start year and subsequent taxation years. In the context of the reserve for life insurers under subsection 138(3), it is intended that paragraph (c) of the definition “reported reserve” in subsection 1408(1) of the Regulations be amended so that the FIE can have a “reported reserve”.

(e) The FIE is deemed not to have been in existence before the fresh-start year for the purposes of sections 37, 65 to 66.4 and 66.7. As a consequence, the scientific research and resource expenditure pools to which these sections refer are ignored, to the extent that these pools were generated before the fresh-start year.

(f) The FIE is not permitted to deduct any amount under subsection 20(11) or (12) in respect of its foreign tax. However, foreign tax will be taken into account because the FIE's specified tax allocation (as defined under subsection 94.3(1)) can offset amounts otherwise included in income under subsection 94.3(4). Further, if the FIE is a trust, no amount is considered deductible under subsection 104(6) in determining its income for the year. Double taxation for the investor taxpayer is avoided through the application of new section 94.4. In addition, no deemed disposition day under subsection 104(4) is determined in respect of the trust, whether the FIE falls outside the restricted meaning of “trust” for this purpose under subsection 108(1) or not.

(g) If the investor taxpayer is a corporation resident in Canada and the FIE is a foreign affiliate of the taxpayer, any dividends received by the FIE from a foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest (as determined under paragraph 95(2)(m)) are not included in the FIE's income. Note, that this rule does not apply in the event that the FIE's interest in the foreign affiliate is subject to the mark-to-market regime in section 94.2. However, an income inclusion resulting from the application of subsection 94.2(4) for the FIE can, in some cases, be offset by the deduction provided under new subsection 94.4(2).

(h) Where the FIE has an interest in another FIE, there is no “deferral amount” taken into account in computing the FIE's income pursuant to new subsection 94.2(4). (The fresh-start rule described above eliminates the need for a “deferral amount”).)

(i) Participating interests in controlled foreign affiliates of the investor taxpayer (rather than controlled foreign affiliates of the FIE) are treated as “exempt interests” of the FIE.

(j) Where the FIE has net capital gains for the particular taxation year, the amount to be included in computing the FIE income in respect of the capital gains is the amount, if any, by which the amount determined under subparagraph 3(b)(i) exceeds the amount determined under subparagraph 3(b)(ii) in respect of the FIE for the year.

(k) Where the FIE has net capital losses for the particular taxation year the amount deductible in computing the FIE income in respect of capital losses (other business investment losses) is the amount, if any, by which the amount determined under subparagraph 3(b)(ii) exceeds the amount determined under subparagraph 3(b)(i) in respect of the FIE for the year.

(l) Where the FIE has business investment losses for the year the amount deducted in computing the entity's income for the year in respect of business investment losses is the amount of its allowable business investment losses for the year.

For further details, see the related commentary on the definitions “foreign investment entity” and “exempt interest” in subsection 94.1(1) and “loss allocation” and “specified tax allocation” in subsection 94.3(1).

### **“loss allocation”**

The definition “loss allocation” applies in determining the amount to be included, under “B” of the formula in subsection 94.3(4), in computing a taxpayer's income or loss for the taxpayer's taxation year in respect of a property that is a participating interest of the taxpayer in a FIE. A taxpayer is entitled, under the formula in subsection 94.3(4), to deduct the taxpayer's loss allocation in respect the participating interest.

In general, a taxpayer's loss allocation in respect of a participating interest, in a non-resident entity, held by the taxpayer at the end of a particular taxation year of the non-resident entity that ends in a taxation year of the taxpayer, is the proportion of the FIE's net loss for the particular taxation year that the fair market value of the taxpayer's participating interest in the FIE is of the fair market value of all

participating interests in the FIE. More specifically, a taxpayer's loss allocation is determined as follows:

- ADD the amount of the entity's total losses for the particular taxation year from businesses and properties, the amount, if any, by which the amount determined under subparagraph 3(b)(ii) exceeds the amount determined under subparagraph 3(b)(i) in respect of the entity for the particular taxation year, and the amount of the entity's allowable business investment losses for the particular taxation year,
- SUBTRACT the amount determined under paragraph 3(c) for the entity for the particular taxation year (i.e., the total amount of its income from businesses and properties and taxable capital gains in excess of allowable capital losses, for the particular taxation year), and
- MULTIPLY any positive remainder by the percentage that the fair market value of the interest represents of the fair market value of all participating interests in the entity. (Note that subsection 94.3(4) is unavailable in respect of a particular interest that would not be a participating interest if the definition "participating interest" in subsection 94.1(1) were read without reference to its paragraph (d).)

The determination of a taxpayer's loss allocation is subject to the same special rules that apply for the purposes of computing a taxpayer's "income allocation" (as defined in subsection 94.3(1)). For more detail, see the commentary on the definition "income allocation".

### **"specified tax allocation"**

The definition "specified tax allocation" applies in determining the amount to be included, under "C" of the formula in subsection 94.3(4), in computing a taxpayer's income or loss for the taxpayer's taxation year in respect of a property that is a participating interest of the taxpayer in a FIE. A taxpayer is entitled to deduct, under C of the formula in subsection 94.3(4), the taxpayer's specified tax allocation in respect of the participating interest

A taxpayer's specified tax allocation in respect of a participating interest, in a FIE, held by the taxpayer at the end of a particular taxation year of the FIE that ends in a taxation year of the taxpayer, means the total of all amounts each of which is the amount determined, in respect of the particular taxation year, by the formula set out in the definition.



More specifically, the taxpayer's specified tax allocation is the product obtained by the following:

- MULTIPLY, if the taxation year of the taxpayer begins after 2002, the income or profits tax paid by the FIE in respect of the particular taxation year, to the extent that that tax can reasonably be considered to be in respect of the income or profits of the FIE included in computing the amount determined in respect of the FIE and the participating interest under the description of “A” in the definition “income allocation” for the particular taxation year or any of the 5 taxation years of the FIE that precede the particular taxation year and that end after 2002, BY
- the percentage that the fair market value of the interest represents of the fair market value of all participating interests in the entity. (Note that subsection 94.3(4) is unavailable in respect of a particular interest that would not be a participating interest if the definition “participating interest” in subsection 94.1(1) were read without reference to its paragraph (d), AND
- MULTIPLY any positive remainder by the taxpayer's relevant tax factor (as defined by subsection 95(1)) for that taxation year of the taxpayer.

Income or profits tax is normally expected to be tax that is paid by an entity to a foreign government. However, it could also include income tax paid to the government of Canada or a province with respect to income earned by the entity from Canadian sources. In each case, only income or profits tax payable for taxation years of entities that end in a taxation year of a taxpayer that begins after 2002 is taken into account.

## **Rules of Application**

ITA  
94.3(2)

New subsection 94.3(2) of the Act sets out rules that apply in applying section 94.3 of the Act.

Paragraph 94.3(2)(a) provides that the rules of application in subsection 94.1(2) apply in section 94.3

Paragraph 94.3(2)(b) identifies a number of circumstances in which subsection 94.3(3) (and hence subsection 94.3(4)) is not available, even

though the conditions in paragraphs 94.3(3)(a) to (e) may be met, for a particular taxation year of a taxpayer in respect of a particular participating interest, in a non-resident entity, held in the particular taxation year by the taxpayer. More specifically those circumstances are:

- where, either of subsection 94.2(3) or subsection 94.2(9) (tracked interests) applies to the taxpayer in respect of the particular participating interest for the particular taxation year,
- where the taxpayer is itself a FIE,
- where the Minister of National Revenue sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to determine if an amount with respect to the particular participating interest would be required under subsection 94.3(4) to be added (or permitted under that subsection to be deducted) in computing the income of the taxpayer for the taxation year, and information satisfactory to the Minister to make the determination is not received by the Minister within 60 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand,
- where the particular participating interest is an interest that would not, at each time in the particular taxation year at which the taxpayer held the particular participating interest and at which a taxation year of the non-resident entity ends, be a participating interest, in the non-resident entity, if the definition “participating interest” were read without reference to paragraph (d) of that definition – that is, without reference to the rule which deems a property that is convertible into, exchangeable for, or confers a right to acquire a participating interest in a FIE or a property the fair market value of which is determined primarily by reference to the fair market value of participating interests in the FIE, to be a participating interest.
- where subsection 94.3(3) applied for a taxation year (the “preceding taxation year”) that ended before the particular taxation year of the taxpayer in respect of the particular participating interest, and did not apply for a taxation year of the taxpayer that was after the preceding taxation year and before the particular taxation year in respect of the particular participating interest. For example, where a taxpayer has sufficient information to apply the accrual regime in one year and in the subsequent year does not. The accrual regime would be unavailable to the taxpayer in respect of the interest and any identical interests in

the subsequent year (because of paragraph 94.3(3)(e)) and any of the following years (because of subparagraph 94.3(2)(b)(v)), or

- where the participating interest is a specified interest (as defined in subsection 94.1(1)) in a trust that is an exempt foreign trust because of paragraph (g) of the definition “exempt foreign trust” in subsection 94(1) and the trust holds, at any time in the particular taxation year, property in respect of which it has waived a right to receive an amount.

## Accrual

### ITA

#### 94.3(3) and (4)

Subsection 94.3(3) provides that the accrual regime is available, subject to the limitations set out in paragraph 94.3(2)(b), to a taxpayer for a particular taxation year of the taxpayer in respect of a particular participating interest, in a non-resident entity, held in the particular taxation year by the taxpayer (and in respect of any other participating interests, in the non-resident entity, that are held in the particular taxation year by the taxpayer and that are identical to the particular participating interest) if

- subsection 94.1(3) applies to the taxpayer for the particular taxation year in respect of the particular participating interest;
- the taxpayer has elected that subsection 94.3(3) apply in respect of the particular participating interest, by notifying the Minister in writing in the taxpayer’s return of income filed on or before the taxpayer’s filing-due date for the first taxation year of the taxpayer for which
  - subsection 94.1(3) applies to the taxpayer in respect of the particular participating interest, or
  - subsection 94.2(9) does not apply to the taxpayer in respect of the particular participating interest and that immediately follows a taxation year for which subsection 94.2(9) applied to the taxpayer in respect of the particular participating interest;
- neither subsection 94.1(4) (i.e., the imputed income regime) nor 94.2(3) (i.e., the mark-to-market regime) applied to the taxpayer for a taxation year (referred to in this commentary as the “preceding

taxation year”) that ended before the particular taxation year in respect of the particular participating interest, unless subsection 94.2(9) applied for that preceding taxation year to the taxpayer in respect of the particular participating interest (or any of the other participating interests);

- the particular participating interest is, at each time in the particular taxation year at which the taxpayer held the particular participating interest (or any of the other participating interests) and at which a taxation year of the non-resident entity ends, capital property of the taxpayer; and
- the taxpayer files, with the taxpayer’s return of income filed on or before the taxpayer’s filing-due date for the particular taxation year, prescribed information in prescribed form. It is contemplated that the prescribed information required would include: the entity’s financial statements (as defined in subsection 94.1(1)); capital cost allowance schedules; capital gains and capital loss calculations; a detailed calculation of the taxpayer’s specified tax allocation and any income allocation or loss allocation; a reconciliation of the entity’s income reported in its financial statement income with its income computed under “A” of the formula in the “income allocation” provisions; and a description of reserves claimed.

If subsection (3) applies to a taxpayer resident in Canada for a particular taxation year of the taxpayer in respect of a participating interest in a non-resident entity, in computing the taxpayer’s income for the particular taxation year, subsection 94.3(4) will apply in computing the taxpayer’s income or loss for the particular taxation year from property from a property that is the participating interest. More specifically, under paragraph 94.3(4)(a), the taxpayer’s income from property from a property that is the participating interest, is the positive amount, if any, determined as follows:

- ADD the taxpayer’s “income allocation” in respect of the participating interest for each taxation year of the non-resident entity that ends in the particular taxation year;
- SUBTRACT the taxpayer’s “loss allocation” in respect of the participating interest for each taxation year of the non-resident entity that ends in the particular taxation year;



- SUBTRACT the taxpayer's specified tax allocation in respect of the participating interest for each taxation year of the non-resident entity that ends in the particular taxation year; and
- SUBTRACT the net cumulative positive balance determined under paragraph 94.3(4)(b) in respect of the taxpayer for such property in respect of preceding taxation years of the non-resident entity.

Where a negative amount results in applying the formula under paragraph 94.3(4)(a), paragraph 94.3(4)(b) may permit a deduction of the negative amount, as a loss from property from a property that is the participating interest, in computing the taxpayer's income for the particular taxation year. However, the deduction is limited by net cumulative positive balance determined under subparagraph 94.3(4)(b)(ii) in respect of the taxpayer for such property in respect of preceding taxation years of the non-resident entity.

An unused loss allocation is treated as a loss from property and is carried forward to offset the total amount otherwise required to be included in computing the taxpayer's income from property under subsection 94.3(4) for a subsequent taxation year of the non-resident entity. For more detail, see the commentary on the definition "loss allocation" in subsection 94.3(1).

The following examples illustrate the operation of subsection 94.3(4).

### ***Example 1***

*Canco owns shares in the capital stock of FIE-1, which like Canco has a calendar taxation year. Canco's income (loss) allocations for, 2003, 2004, 2005, 2006 and 2007 are (\$100), \$25, \$90, (\$20) and \$50, respectively. FIE-1 pays no income or profits taxes.*

### ***Results***

1. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2003 is nil ( $B = \$100$ ). The amount determined under paragraph 94.3(4)(b) for 2002 is \$100, which can be carried forward to 2004.*
2. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2004 is nil ( $A = \$25$ ,  $D = \$100$ ). The amount determined under paragraph 94.3(4)(b) for 2004 is \$75, which can be carried forward to 2005.*

3. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2005 is \$15 ( $A = \$90$ ,  $D = \$75$ ). The amount determined under paragraph 94.3(4)(b) for 2005 is nil.*
4. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2006 is nil ( $B = \$20$ ,  $D = \$0$ ). The amount deductible under paragraph 94.3(4)(b) is \$15 (= the lesser of \$20 and \$15). The remaining \$5 unused loss allocation can be carried forward to 2007.*
5. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2007 is \$45 ( $A = \$50$ ,  $D = \$5$ ).*

### **Example 2**

*Canco owns shares in the capital stock of FIE-1, which like Canco has a calendar taxation year. Canco's income (loss) allocations for, 2003, 2004, 2005, 2006 and 2007 are: (\$100), (\$125), (\$175), \$300 and \$150. FIE-1 pays no income or profits taxes.*

### **Results**

1. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2003 is nil ( $B = \$100$ ). The amount determined under subparagraph 94.3(4)(b)(i) for 2002 is \$100 (=  $B$ ), which can be carried forward to 2004.*
2. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2004 is nil ( $B = \$125$ ,  $D = \$100$ ). The amount determined under subparagraph 94.3(4)(b)(i) for 2004 is \$225 (=  $B+D$ ), which can be carried forward to 2005.*
3. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2005 is nil ( $B = \$175$ ,  $D = \$225$ ). The amount determined under subparagraph 94.3(4)(b)(i) for 2005 is \$400 (=  $B+D$ ).*
4. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2006 is nil ( $A = \$300$ ,  $D = \$400$ ). The amount deductible under paragraph 94.3(4)(b) is nil (= the lesser of \$100 and nil). The remaining \$100 unused loss allocation (=  $D - A$ ) can be carried forward to 2007.*

5. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2007 is \$50 ( $A = \$150$ ,  $D = \$100$ ).*

### **Example 3**

1. *Canco, FIE-1 and ABC Inc. each have taxation years that coincide with calendar years and each issue only one class of shares.*
2. *Canco is a corporation resident in Canada that holds 20% of the shares of the capital stock of FIE-1.*
3. *FIE-1 owns 75% of the shares of the capital stock of ABC Inc.*
4. *ABC Inc. is not a FIE, but would be a controlled foreign affiliate of FIE-1 if FIE-1 were resident in Canada. Although ABC Inc. is a foreign affiliate of Canco, it is not a controlled foreign affiliate of Canco.*
5. *FIE-1 earns \$5,000 in interest income in 2003. It also receives a dividend of \$1,000 from ABC Inc. FIE-1 pays no income or profits taxes.*
6. *The fair market value of FIE-1's shares in ABC Inc. increases by \$6,500 in 2003.*

### **Results**

1. *Under the definition "income allocation" in subsection 94.3(1), Canco is required to compute its share of FIE-1's income. For this purpose, FIE-1's income is generally computed as if FIE-1 were resident in Canada. Canco is required, under "A" of the formula in paragraph 94.3(4)(a), to include in computing income its income allocation in respect of its shares in the capital stock of FIE-1.*
2. *FIE-1's income, in computing Canco's income allocation, includes the \$5,000 of interest income (as per paragraph 12(1)(c)). However, the \$1,000 dividend from ABC Inc. is disregarded because of paragraph (g) of "A" in the definition "income allocation".*

3. *Section 91 of the Act is not applicable in computing Canco's income allocation in respect of its shares in FIE-1 because of paragraph (a) of "A" in the definition "income allocation".*
4. *Since ABC Inc. is not a FIE, sections 94.1 to 94.4 are not applicable to FIE-1's interest in ABC Inc. in computing Canco's income allocation in respect of its shares in FIE-1.*
5. *Canco's income allocation, therefore, is \$1,000 (i.e., 20% x \$5,000). This amount is included under "A" of the formula in paragraph 94.3(4)(a).*

#### **Example 4**

*Same facts as in example 3, except that ABC Inc. is itself a FIE.*

#### **Results**

1. *Because of subparagraph 94.3(2)(b)(ii), the accrual regime will not apply in the calculation of FIE-1's income in respect of its interest in ABC Inc. Instead, FIE-1 may rely upon subsections 94.2(3) and (4), and if not applicable, subsection 94.1(4). Assume that FIE-1 qualifies, and so elects, to have subsection 94.2(3) apply to it in respect of its interest in ABC Inc. Thus, the mark-to-market regime under subsection 94.2(4) will apply to determine its FIE income from the interest.*
2. *For the purpose of computing Canco's income allocation in respect of its shares in FIE-1, FIE-1's income would include the \$5,000 of interest (as per example 3), but not include any share of foreign accrual property income (as per example 3). However, FIE-1's income would include the \$1,000 dividend paid in addition to its gain determined under subsection 94.2(4) in respect of its participating interest in ABC Inc. This gain so determined is \$7,500, which is equal to the \$6,500 increase in the value of shares plus the \$1,000 dividend paid. However, for the purposes of computing Canco's income allocation, a deduction for the \$1,000 dividend is permitted for FIE-1 because section 94.4 would have permitted the deduction if FIE-1 had been resident in Canada.*



3. Consequently, Canco's income allocation in respect of its shares of the capital stock of FIE-1 is equal to \$2,500 [i.e.,  $(\$5,000 + \$7,500 + \$1,000 - \$1,000) \times 20\%$ ]. This amount is required to be included in computing Canco's income under subsection 94.3(4).

### Example 5

In 1999, Mireille (a resident of Canada) purchased a 30% participating interest in an entity (FIE-1) that is a FIE. The rate of foreign tax applicable to FIE-1's income is 20%. FIE-1's taxation years coincide with calendar years. For the purposes of computing Mireille's income or loss in respect of the interest under subsection 94.3(4), the income (loss) and the foreign tax of FIE-1 for taxation years 2003 to 2006 are as follows:

Year	2003	2004	2005	2006	Total
<b>Income (loss)</b>	\$ 100,000	(\$120,000)**	\$95,000	\$130,000	\$205,000
<b>Foreign tax paid*</b>	\$20,000	Nil	Nil	\$21,000	\$41,000

\* Assume foreign tax paid in the same taxation year as liability arose.

\*\* Assume that an equivalent amount is carried forward under the laws of the relevant foreign jurisdiction to reduce FIE-1's tax liabilities after 2004.

### Results

Mireille's income allocations, loss allocations and specified tax allocations are shown in the table below, as are the resulting income inclusions and deductions under subsection 94.3(4). The specified tax allocations in the table below are obtained by multiplying the related figures in the above table by 30% (Mireille's percentage interest) and 2.2 (specified tax factor for Mireille). For example, for 2003 Mireille's specified tax allocation is \$13,200 ( $\$20,000 \times 30\% \times 2.2$ ).

<i>Year</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>
<i>A. Income/Loss allocation</i>	\$30,000	(\$36,000) <i>l</i>	\$28,500	\$39,000
<i>B. Specified tax allocation</i>	(\$13,200)	<i>nil</i>	<i>nil</i>	(\$13,800)
<i>C. Loss allocation (used)</i>	<i>nil</i>	(\$16,800)	<i>nil</i>	<i>nil</i>
<i>D. Carry-forward offset used</i>	<i>nil</i>	<i>nil</i>	(\$19,200)	<i>nil</i>
<i>E. Loss allocation/ tax allocation to carry-forward</i>	<i>nil</i>	(\$19,200)	<i>nil</i>	<i>nil</i>
<i>Amount included in income under subsection 94.3(4)</i>  <i>(A - B - C - D)</i>	\$16,800	<i>nil</i>	\$9,300	\$25,200
<i>Amount deducted in computing income under subsection 94.3(4)</i>  <i>(D + C + B - A)</i>	<i>nil</i>	(\$16,800)	<i>nil</i>	<i>nil</i>

### Adjusted Cost Base

#### ITA

#### 94.3(5)

New subsection 94.3(5) of the Act provides for adjustments to the adjusted cost base (ACB) of a participating interest in an entity held by a taxpayer.

Paragraph 94.3(5)(a) provides for an addition to the ACB of a taxpayer of a participating interest, in a non-resident entity, at any time of the amount that is the total of the amount included in computing the taxpayer's income under paragraph 94.3(4)(a) for a taxation year of the

taxpayer that ended before that time and the product obtained when the amount determined under paragraph (j) of the description of “A” in the definition “income allocation” in subsection 94.3(1) (taxable capital gains of the non-resident entity) in respect of the taxpayer and the participating interest for a particular taxation year of the non-resident entity that ended in a taxation year of the taxpayer that ended before that time and at the end of which particular taxation year the taxpayer held the participating interest is multiplied by the percentage that the fair market value of the interest represents of the fair market value of all participating interests in the entity.

Conversely, paragraph 94.3(5)(b) provides for a reduction to the ACB of a taxpayer of a participating interest, in a non-resident entity, at any time, of the total of three amounts. The first is the amount deducted, as a loss from a property that is the participating interest, under paragraph (4)(b) in computing the taxpayer's income for a taxation year of the taxpayer that ended before that time. The second and third amounts are the product obtained when the amount determined under paragraph (k) or (l), as the case may be, of the description of A in the definition “income allocation” (allowable capital losses of the non-resident entity and allowable business investment losses of the non-resident entity) in respect of the taxpayer and the participating interest for a particular taxation year of the non-resident entity that ended in a taxation year of the taxpayer that ended before that time and at the end of which particular taxation year the taxpayer held the participating interest is multiplied by the percentage that the fair market value of the interest represents of the fair market value of all participating interests in the entity.

For more information, see the commentary on new paragraphs 53(1)(m.1) and 53(2)(w).

## **Prevention of Double Taxation**

### **ITA 94.4**

New section 94.4 provides rules to eliminate double taxation of income where an amount of income of a non-resident entity, in respect of which any of sections 94.1 to 94.3 has applied in calculating the income for a year of a holder of an interest in the non-resident entity, becomes payable (determined by reference to paragraph 94.1(2)(o)), to that interest holder.

Subsection 94.4(1) provides that the definitions in subsections 94.1(1), and the rules of application in subsection 94.1(2) and paragraph 94.2(2)(a), apply in section 94.4.

Under subsection 94.4(2), where an amount becomes payable (at a particular time in a particular taxation year of a taxpayer that begins after 2002 or in a preceding taxation year of the taxpayer that begins after 2002) to the taxpayer from a non-resident entity in respect of a participating interest in the entity held by the taxpayer (otherwise than as consideration for the disposition of the interest), and the taxpayer is resident in Canada at the particular time, a deduction is permitted to offset (against any income included in respect of the interest under subsection 94.1(4) or 94.2(4)) any net income inclusion resulting from the amount payable.

The permitted deduction for the taxpayer's taxation year is equal to the lesser of:

- the amount, if any, by which the total of those amounts payable that are included (otherwise than because of subsection 94.2(4)) in computing the taxpayer's income for any of those years, exceeds the total of all amounts deductible in respect of the participating interest in any of those preceding years under paragraph 94.4(2)(a), and
- the amount, if any, by which the total of
  - the amounts included (or that, but for subsection 94.2(20), would have been included) in respect of the participating interest under subsection 94.1(4) or 94.2(4) in computing the taxpayer's income for the taxation year or a preceding taxation year, and
  - the amounts required by paragraph 94.3(5)(a) to be added in computing at the particular time the adjusted cost base to the taxpayer of the participating interest
- exceeds the total of all amounts each of which is an amount, in respect of the participating interest,
- that is required by paragraph 94.3(5)(b) or paragraph 94.4(4)(b) to be deducted in computing at the particular time the adjusted cost base to the taxpayer of the participating interest,



- that is deducted (or that, but for subsection 94.2(20), would have been deducted) under subsection 94.2(4) in computing the taxpayer's income for any of those taxation years, or
- that is deducted under paragraph 94.4(2)(a) in computing the taxpayer's income for any of those preceding taxation years.

The amount deducted from income under paragraph 94.4(2)(a) in respect of the interest must also be deducted in computing the adjusted cost base of the interest. For more information, see the commentary on new paragraph 53(2)(w).

The example below illustrates the operation of subsection 94.4(2).

### ***Example***

1. *A taxpayer resident in Canada, Canco, purchases a 20% interest in Foreignco, a non-resident corporation. Foreignco is a FIE. Participating interests in Foreignco do not qualify as "exempt interests". Both Canco and Foreignco have taxation years that coincide with calendar years. Subsection 94.1(4) applies to Canco in respect of the interest.*
2. *Canco's income under subsection 94.1(4) in respect of its participating interest in Foreignco for 2003 is \$100,000. Foreignco pays a dividend of \$50,000 to Canco in 2003. Canco includes the dividend in income pursuant to section 90 and claims a deduction of \$20,000 in computing its taxable income pursuant to subsection 113(1). No foreign withholding taxes were paid by Canco on the \$50,000 dividend.*

### ***Results***

1. *Canco's deduction from income under subsection 94.4(2) is equal to \$50,000, being the lesser of the income inclusion as a result of the payment (= \$50,000) and the amount of the income inclusion under subsection 94.1(4) (\$100,000).*
2. *The result would generally be the same if the \$50,000 dividend were instead paid in a subsequent year.*

Under subsection 94.4(3), if a particular amount is included in computing, in respect of a taxpayer, the amount determined under subparagraph 94.4(2)(a)(i) in respect of the taxpayer's participating

interest in a foreign investment entity (other than, where the taxpayer is a corporation, a foreign investment entity that is, at the time the particular amount was received by the taxpayer, a foreign affiliate of the taxpayer) for a taxation year of the taxpayer, the taxpayer may deduct in computing the taxpayer's income for the taxation year the product obtained when the taxpayer's relevant tax factor (as defined by subsection 95(1)) for the taxation year is multiplied by the lesser of

- the amount of non-business income tax (as defined in subsection 126(7)) paid by the taxpayer for the taxation year in respect of the particular amount, and
- 15% of the amount determined under subparagraph 94.3(2)(a)(ii) in respect of the participating interest of the taxpayer for the taxation year.

Subsection 94.4(3) is relevant where a FIE distribution is made in respect of a taxpayer's participating interest and the distribution is subject to non-business income tax imposed by the government of a country in which the FIE is resident. Because of new subsection 126(1.2) of the Act, described in the commentary below, a taxpayer is not entitled to a tax credit under subsection 126(1) in respect of non-business income tax paid by a taxpayer in respect of the distribution if the taxpayer made a deduction under subsection 94.4(3) in respect of the particular amount.

Under subsection 94.4(4), where an amount becomes payable (at a particular time in a particular taxation year of a taxpayer that begins after 2002 or in a preceding taxation year of the taxpayer that begins after 2002) to the taxpayer from a non-resident entity in respect of a participating interest in the entity held by the taxpayer (otherwise than as consideration for the disposition of the interest), and the taxpayer is resident in Canada at the particular time, a deduction is permitted to offset (against any income included in respect of the interest under subsection 94.3(4)) any net income inclusion resulting from the amount payable.

More specifically, the permitted deduction for the taxpayer's taxation year is equal to the lesser of:

- the amount, if any, by which the total of those amounts payable that are included (otherwise than because of subsection 94.2(4)) in computing the taxpayer's income for any of those years, exceeds

the total of all amounts deducted in respect of the participating interest in any of those preceding years under paragraph 94.4(2)(a) or 94.4(4)(a) or deductible in respect of the participating interest in any of those preceding years under subsection 91(5) or section 113, in computing the taxpayer's income or taxable income, as the case may be, and

- the amount, if any, by which the total additions required by paragraph 94.3(5)(a) in computing at the particular time the taxpayer's ACB of the participating interest exceeds the total of the deductions required by paragraph 94.3(5)(b) in computing that ACB and the deductions under paragraph 94.4(4)(a) in respect of the participating interest in computing the taxpayer's income for any of those preceding taxation years.

The amount deducted from income under paragraph 94.4(4)(a) in respect of the interest must also be deducted in computing the adjusted cost base of the interest. For more information, see the commentary on new paragraph 53(2)(w).

## **Clause 17**

### **Foreign Affiliates**

ITA

95

Section 95 of the Act defines a number of terms and provides certain rules relating to the taxation of resident shareholders of foreign affiliates.

### **Definitions**

ITA

95(1)

Subsection 95(1) of the Act sets out definitions that are relevant for the purposes of sections 90 to 95.

Subsection 95(1) is amended so that these definitions do not apply for the purposes of sections 94 to 94.4, except where the definition applies for the purposes of the Act as a whole because of subsection 248(1). This amendment applies to taxation years that begin after 2002.

As set out below, various definitions in subsection 95(1) are also being amended.

### **“controlled foreign affiliate”**

The income for a taxation year of a taxpayer resident in Canada includes, under subsection 91(1) of the Act, a specified percentage of the foreign accrual property income (FAPI) of any controlled foreign affiliate of the taxpayer. In order to eliminate overlap between the FAPI rules and the rules for foreign investment entities in sections 94.1 and 94.2, the latter rules generally do not apply in respect of a taxpayer's interest in a controlled foreign affiliate of a taxpayer resident in Canada. An election is provided under new paragraph 94.1(2)(h) under which a foreign affiliate of a taxpayer can be treated as the taxpayer's controlled foreign affiliate.

The definition “controlled foreign affiliate” is amended to refer to foreign affiliates that are deemed by paragraph 94.1(2)(h) to be controlled foreign affiliates.

This amendment applies to taxation years that begin after 2002.

### **“foreign accrual property income”**

The FAPI of a controlled foreign affiliate of a taxpayer resident in Canada is allocated to the taxpayer in accordance with subsection 91(1) of the Act. Under its definition in subsection 95(1), FAPI includes certain amounts that would be included in the affiliate's income under existing subsection 94.1(1) if that subsection were read in the manner specified in the description of C of the definition.

Existing section 94.1 is being repealed. Accordingly, the description of C in the definition “foreign accrual property income” is also repealed. There are, however, special rules in new paragraph 95(2)(g.3) with regard to the application of sections 94.1 to 94.4. Amounts determined under paragraph 95(2)(g.3) will be included in FAPI under the description of “A” in the definition “foreign accrual property income”. For detail on paragraph 95(2)(g.3), see the commentary on that paragraph.

This amendment applies to taxation years that begin after 2002.



## **“relevant tax factor”**

The definition “relevant tax factor” in subsection 95(1) of the Act is used in determining the Canadian tax relief provided in respect of foreign taxes imposed on the earnings of a foreign affiliate of a taxpayer or a foreign investment entity in which the taxpayer has a “participating interest” (as defined in subsection 94.1(1)). The existing definition provides that the relevant tax factor for a corporation (or a partnership all the resident members of which are corporations) is the reciprocal of the basic corporate tax rate (i.e.,  $1/.38$ , or  $2.63$ ). The factor for individuals and other partnerships is  $2$ .

As part of a series of amendments reflecting recent and planned reductions in income tax rates, the definition “relevant tax factor” is amended. The relevant tax factor for a corporation (or a partnership all the resident members of which are corporations) will take account of the “general rate reduction percentage” provided in section 123.4 of the Act. For example, if a corporation’s taxation year is the calendar year, its relevant tax factor for 2003 will be  $1/ (.38 - .05)$ , or  $3.03$ .

Similarly, to take account of decreasing personal income tax rates, the relevant tax factor for individuals and other partnerships is increased to  $2.2$ .

These amendments apply to the 2002 and subsequent taxation years.

## **Foreign Investment Entities**

ITA  
95(2)

Subsection 95(2) of the Act provides rules for determining the income of a foreign affiliate of a taxpayer resident in Canada. These rules apply for the purposes of sections 90 to 95.

New paragraph 95(2)(g.3) applies to a particular foreign affiliate of a particular Canadian taxpayer for a particular taxation year of the particular foreign affiliate, in respect of a property that is a participating interest, in a particular non-resident entity held by the particular foreign affiliate in the particular taxation year. In this case, sections 94.1 to 94.4 apply in respect of the particular participating interest as if

- The particular affiliate were, with some exceptions, a taxpayer resident in Canada throughout the particular year;

- The exemption in paragraph (a) of the definition “exempt interest” for controlled foreign affiliates referred only to controlled foreign affiliates of the Canadian taxpayer;
- An exempt interest of particular affiliate in a non-resident entity included a participating interest held, in the particular taxation year, by the particular foreign affiliate, and used or held by the particular foreign affiliate principally for the purpose of gaining or producing income from an active business;
- A “fresh-start year” (relevant in computing the foreign affiliate’s “income allocation” and “loss allocation” under the accrual regime in section 94.3) of the particular non-resident entity in respect of the particular affiliate were its taxation year (at the end of which the particular affiliate holds an interest in it and it is a foreign investment entity and at any time in which the particular affiliate is a CFA of the Canadian taxpayer) that ends in a taxation year of the particular affiliate that begins after 2002 and that immediately follows a taxation year of the particular non-resident entity in respect of which subsection 94.1(3) would not have been applicable to the foreign affiliate.
- The exclusion of dividends under paragraph (g) of the description of A in the definition “income allocation” in subsection 94.3(1) applies only where the Canadian taxpayer is resident in Canada, in connection with dividends received by the particular affiliate from foreign affiliates of the Canadian taxpayer (not of the particular affiliate);
- The Canadian taxpayer (rather than the particular affiliate) were required to make a number of the elections, designations, notifications and provisions of information under sections 94.1 to 94.4 in connection with the particular affiliate’s participating interests in foreign investment entities. In addition, the Minister in sending a demand for information to the particular affiliate under subparagraph 94.1(2)(e)(iii) or 94.3(2)(b)(iii), or any of paragraphs 94.1(2)(p) to (r) or 94.2(2)(e), is required to send the demand also to the Canadian taxpayer in connection with the particular affiliate’s participating interests in foreign investment entities.
- In applying subparagraph 94.3(2)(b)(ii), the particular foreign affiliate were not a foreign investment entity, so that a controlled

foreign affiliate that is a foreign investment entity can use the accrual rules in section 94.3;

- The definition “income allocation” in subsection 94.3(1) were read without reference to paragraph (i) of the description of “A”;
- The particular affiliate's “deferral amount” determined under the definition of that expression in subsection 94.2(1) does not include the portion of the amount that can reasonably be considered to have accrued during the period that the particular affiliate was not a foreign affiliate of the Canadian taxpayer and certain other specified persons; and
- The reference in subsection 94.2(19) to the expression “in computing the capital dividend account of the corporation” were read in respect of the affiliate as a reference to the expression “in computing the amount prescribed to be the particular affiliate’s exempt surplus and taxable surplus in respect of the taxpayer”.

This amendment applies to taxation years that begin after 2002.

## **Clause 18**

### **Partnerships and their Members**

ITA

96

Section 96 of the Act provides general rules for determining the income or loss of a partnership and its members.

### **Computing Partnership Income**

ITA

96(1)(d)

Under subsection 96(1), the income earned and losses incurred by a partnership are generally calculated at the partnership level and attributed to partners in accordance with their respective interests in the partnership.

Paragraph 96(1)(d) is amended so that, where at any time in a particular taxation year of the partnership the partnership’s property includes a participating interest in a particular non-resident entity, sections 94.1 to

94.4 apply to the partnership – in computing its income from property from a property that is the participating interest -- for the particular taxation year in respect of the participating interest as if

- The exemption in paragraph (a) of the definition “exempt interest” for controlled foreign affiliates is treated as if it referred only to controlled foreign affiliates of the Canadian taxpayer;
- A “fresh-start year” (relevant in computing the partnership’s “income allocation” and “loss allocation” under the accrual regime in section 94.3) of the particular non-resident entity in respect of the partnership were its taxation year (at the end of which the partnership holds an interest in it and it is a foreign investment entity) that ends in a taxation year of the particular affiliate that begins after 2002 and that immediately follows a taxation year of the particular non-resident entity in respect of which subsection 94.1(3) would not have been applicable to the particular;
- An election under paragraph 94.1(2)(h) – to treat a foreign affiliate of the partnership as its controlled foreign affiliate -- is to be made by a member of the partnership and not by the partnership and can be made only if all of the members of the partnership that were resident in Canada would have qualifying interests (as defined in paragraph 95(2)(m)) in the foreign affiliate based on certain assumptions;
- A member of the partnership (rather than the partnership) is required to make a number of the elections, designations, notifications and provisions of information under sections 94.1 to 94.4 in connection with the partnership’s participating interests in foreign investment entities. In addition, the Minister in sending a demand for information to the particular affiliate under subparagraph 94.1(2)(e)(iii) or 94.3(2)(b)(iii), or any of paragraphs 94.1(2)(p) to (r) or 94.2(2)(e), is required to send the demand also to the member in connection with the partnership’s participating interests in foreign investment entities.
- The definition “income allocation” in subsection 94.3(1) were read without reference to paragraph (i) of the description of “A”; and



- In applying subparagraph 94.3(2)(b)(ii), the partnership were not a foreign investment entity, so that a controlled foreign affiliate that is a foreign investment entity can use the accrual rules in section 94.3.

This amendment applies to fiscal periods that begin after 2002.

### **Application of sections 94.1 and 94.2**

ITA

96(1.9)

New subsection 96(1.9) of the Act is relevant where an “exempt taxpayer” (in general, an individual who has been resident in Canada for fewer than 60 months) is a member of a partnership and the partnership invests in a foreign investment entity. In these circumstances, the exempt taxpayer's share of the partnership's income or loss is computed without regard to sections 94.1 to 94.4. For further details on the application of section 94.2 to partnerships, see the commentary on new subsections 94.2(6) to (8).

This amendment applies to fiscal periods of partnerships that begin after 2002.

### **Agreement or Election of Partnership Members**

ITA

96(3)

Subsection 96(3) of the Act provides rules that apply if a member of a partnership makes an election under certain provisions of the Act for a purpose that is relevant to the computation of the member's income from the partnership. In such a case, the election will be valid only if it is made on behalf of all the members of the partnership and the member had authority to act for the partnership.

Subsection 96(3) is amended so that it applies for the purposes of elections under

- new sections 94.1 and 94.2; and
- paragraph 95(2)(g.2).

This amendment applies to fiscal periods of partnerships that begin after 2002.

### **Application of Foreign Partnership Rule**

ITA  
96(9)

Subsection 96(8) of the Act provides rules that apply where, at a particular time, a Canadian resident becomes a member of a partnership, or a person who is a member of such a partnership becomes a resident of Canada. Where, immediately before the particular time no member of the partnership was resident in Canada, these rules apply in computing the income of the partnership for fiscal periods ending after the particular time. In general terms, the rules in subsection 96(8) are designed to prevent losses accrued while a partnership had no Canadian resident partners from being used to reduce Canadian income tax liabilities.

Subsection 96(9) provides that, where one of the main reasons that there is a member of the partnership who is resident in Canada is to avoid the application of subsection 96(8), that member will, for the purpose of applying subsection 96(8), be considered not to be resident in Canada.

Subsection 96(9) is amended to provide an explicit look-through rule for the purposes of subsection 96(8) so that members of partnerships may be identified through one or more tiers of partnerships that are members of other partnerships. Amended subsection 96(9) is consistent with new subsection 94.2(8).

This amendment applies to partnership fiscal periods that begin after June 22, 2000.

### **Clause 19**

#### **Contributions of Property to a Partnership**

ITA  
97(2)

Subsection 97(2) of the Act provides rules that allow a person to transfer certain types of property on a tax-deferred “rollover” basis to a partnership.

Subsection 97(2) is amended so that it does not apply to a transfer of property that is a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified participating interest” in subsection 248(1), see the commentary on that definition.

This amendment applies to dispositions that occur in taxation years that begin after 2002.

## **Clause 20**

### **Disposition of Partnership Property**

ITA  
98

Section 98 provides rules relating to the taxation of partnership properties and partnership interests where the partnership has ceased to exist.

ITA  
98(7)

New subsection 98(7) of the Act applies if at a particular time a partnership ceases to exist. In this case, the partnership is, at a time (the “disposition time”) that is three instants before the particular time, deemed

- to have disposed of each of its properties that is at the disposition time a specified participating interest for proceeds of disposition equal to the property’s fair market value at the disposition time; and
- to have acquired the property immediately after the disposition time at a cost equal to that fair market value.

This amendment applies to fiscal periods that begin after 2002.

## Clause 21

### Trusts and their Beneficiaries

ITA

104

Section 104 of the Act provides rules governing the tax treatment of trusts and their beneficiaries.

ITA

104(4)(a), (a.5) and (c)

Subsection 104(4) of the Act sets out what is generally referred to as the “21-year deemed realization rule” for trusts. The purpose of subsection 104(4) is to prevent the use of trusts to defer indefinitely the recognition for tax purposes of gains accruing on capital property. Subsection 104(4) generally treats capital property of a trust (other than certain trusts for the benefit of a spouse or common-law partner) as having been disposed of and reacquired by the trust every 21 years at the property's fair market value.

Subparagraph 104(4)(a)(i.1) is amended to apply to a trust to which property is transferred in circumstances to which paragraph 70(5.2)(c) applied. It is also amended to ensure that it continues to apply to a trust to which property was transferred in circumstances to which paragraph 70(5.2)(b) or (d) applied as those paragraphs read in their application to taxation years that began before 2003.

Paragraph 104(4)(a.5) is introduced to provide for a deemed disposition day for a trust that is deemed by subsection 94(3) to be resident in Canada for a taxation year for the purpose of computing the trust's income for the year. The deemed disposition day is the day (in that taxation year) on which, because a “contributor” (as defined in subsection 94(1) of the Act) to the trust either ceases to be resident in Canada or ceases to be a contributor to the trust because of the application at any time of paragraph 94(2)(i), there is no resident contributor to the trust (or the only resident contributors to the trust are entities each of which is an entity the maximum amount recoverable from which under the provisions referred to in paragraph 94(3)(d) is limited to the entities' recovery limits determined under subsection 94(8)). However, no deemed disposition will occur under paragraph 104(4)(a.5) if subsection 94(5) applies in respect of the contributor



ceasing on that day to be a resident contributor of the trust. For more information on section 94, see the commentary on that section.

Paragraph 104(4)(c) is amended so that there is not a deemed disposition day for a trust 21 years after any day determined under new paragraph 104(4)(a.5).

These amendments apply to trust taxation years that begin after 2002. They also apply to trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

#### ITA 104(4.1)

New subsection 104(4.1) of the Act provides that, for the purposes of the deemed disposition rule in subsection 104(4), a property's status as capital property is determined without reference to new subparagraph 39(1)(a)(ii.3). As a result, if subsection 94.2(3) applies for a taxation year to a taxpayer that is a trust in respect of a participating interest of the trust and the trust is deemed to have disposed of the interest because of the application of subsection 104(4), there is a recognition of the "deferral amount" in applying subsection 94.2(4).

This amendment applies to trust taxation years that begin after 2002.

#### ITA 104(6)

Subsection 104(6) of the Act generally permits a trust to deduct, in computing income for a taxation year, any income payable to a beneficiary under the trust.

Subsection 104(6) is amended so that it is expressly subject to subsections 104(7) and 104(7.01).

This amendment applies to trust taxation years that begin after 2002. It also applies to trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

ITA  
104(7.01)

Subsection 104(6) generally permits a trust to deduct, in computing income for a taxation year, an amount not exceeding the portion of its income for the year that becomes payable in the year to a beneficiary. Because of subsection 104(24), trust income is deemed not to have become payable in the year to a beneficiary unless it is paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount.

New subsection 104(7.01) of the Act restricts the amount that a trust, that is deemed by subsection 94(3) to be resident in Canada (referred to in this commentary as a “subsection 94(3) trust”), can deduct under subsection 104(6) in computing its income in the event that the trust has Canadian-source income and makes distributions to beneficiaries not resident in Canada.

In effect, subsection 104(7.01) acts as a proxy for taxes under Parts XII.2 and XIII of the Act in connection with Canadian-source income that has become payable by a subsection 94(3) trust to its non-resident beneficiaries.

New subsection 94(3) deems a trust to which it applies to be resident in Canada for certain purposes, not including Part XII.2. Accordingly, a trust that is resident in Canada solely because of the deeming provision in subsection 94(3) would generally be non-resident for purposes of Part XII.2. Because of an existing exemption for non-resident trusts in Part XII.2, a tax under that Part does not apply to such a trust.

A subsection 94(3) trust is also exempt from Part XIII withholding obligations on Canadian-source income that becomes payable in the year by a resident of Canada to non-resident persons because these subsection 94(3) trusts are not treated by new subsection 94(3) as resident in Canada for the purpose of Part XIII tax.

However, to ensure that subsection 94(3) trusts are not inappropriately used to distribute Canadian-source income free of tax to non-resident beneficiaries, subsection 104(7.01) limits the amount of any trust deduction under subsection 104(6) for such distributions, thereby ensuring the income is subject to Part I tax in the trust.

(It should also be noted that Canadian residents that pay an amount to a subsection 94(3) trust are still liable for a withholding obligation under

section 215 of the Act notwithstanding that the trust itself is exempt from Part XIII tax. This is because new paragraph 94(4)(b) provides that the deemed Canadian residence under subsection 94(3) does not apply for the purposes of determining withholding tax under section 215. The Canada Customs and Revenue Agency will hold the withholding taxes paid and apply them on account of the trust's Part I tax liability. The existing provisions of the Act do not expressly give a Part XIII exemption in this regard to trusts that are subject to existing subsection 94(1). Instead, existing subparagraph 94(1)(c)(ii) allows a tax credit to be claimed by those trusts under section 126 in connection with Part XIII tax on payments made to those trusts.)

As mentioned above, subsection 104(7.01) reduces the maximum deduction under subsection 104(6). More specifically, the amount by which the maximum deduction under subsection 104(6) for a taxation year is reduced under subsection 104(7.01) is equal to the total of:

- the trust's "designated income" for the year (as defined in Part XII.2) payable in the year to a non-resident beneficiary under the trust in respect of an interest of the non-resident as a beneficiary under the trust, and
- all amounts each of which is the product obtained by multiplying a specified factor by each particular amount that is paid or credited in the year to the trust that would, disregarding express provisions to the contrary in the Act, be subject to Part XIII tax and that is payable in the year to a non-resident beneficiary under the trust in respect of an interest of the non-resident as a beneficiary under the trust.

The specified factor in respect of each particular amount described in the second paragraph above is 0.35, if the trust can establish to the satisfaction of the Minister of National Revenue that the non-resident beneficiary to whom the particular amount is payable is resident in a country with which Canada has a tax treaty under which the income tax that Canada may impose on the beneficiary in respect of the amount is limited. In any other case, the specified factor is 0.6.

This amendment applies to trust taxation years that begin after 2002. It also applies to trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

The example below illustrates the operation of new subsection 104(7.01).

### ***Example***

1. *Trust X is an offshore trust established by Stefan, a long-term resident of Canada. The primary beneficiaries under the trust are Linda (a resident of Canada), Tim (a resident of non-Treatyland) and Bart (a resident of the United States).*
2. *Trust X receives \$1,600 of income in its 2003 taxation year. This income consists of \$400 of taxable dividends received from a taxable Canadian corporation. The remaining \$1,200 of income is from other sources, none of which is "designated income" (as defined in Part XII.2) of the trust.*
3. *\$1,050 of Trust X's income for 2003 is made payable in the year to Bart. Of this amount, \$100 represents the taxable dividends. Trust X makes payable \$200 of its income to Tim. Of this amount, \$200 represents the taxable dividends. The remaining \$350 of the trust's income is made payable in the year to Linda. Of this amount, \$100 represents the taxable dividends.*
4. *Trust X is assumed to have designated the \$400 of taxable dividends under subsection 104(19). (Where a designation under subsection 104(19) is available and the designation is made, the designated portion of the dividend income of the trust will, for the purposes of the Act (other than Part XIII), maintain its character, as dividend income, in the hands of the beneficiary.)*

### ***Results***

1. *Because Trust X has a resident contributor at the end of its 2003 taxation year, the trust is deemed by new subsection 94(3) to be resident in Canada for the purposes of computing its income.*
2. *Before taking into account any deduction under subsection 104(6), Trust X's income is \$1,600. Note that the \$400 in dividends is included in computing the trust's income.*
3. *Before taking into account new subsection 104(7.01), the maximum deduction under subsection 104(6) is also \$1,600.*



4. *Because of subsection 104(7.01), the maximum deduction under subsection 104(6) is reduced to \$1,445 (i.e., \$1,600 minus the total of: nil + ((.60 x \$200) and (0.35 x \$100))).*
5. *Assuming that the trust claims a deduction of \$1,445 under subsection 104(6), the trust would consequently have income of \$155. If a tax rate of 42.92% were assumed (i.e., combined federal rates of 29% (because of subsections 122(1) and 117(2) and 13.92% (because of subsection 120(1)), the trust would be liable for Canadian income tax of approximately \$67. Note that the trust is exempt from having to collect a Part XIII tax in respect of the amounts made payable to Bart and Tim, because the trust is not treated by new subsection 94(3) as resident in Canada for this purpose. Disregarding this exemption, the Part XIII tax that would have had to have been collected by the trust in respect of the amounts made payable to Bart and Tim would have been \$65 (i.e., 25% of \$200 and 15% of \$100).*

## ITA 104(21.3)

Subsection 104(21.3) of the Act defines the expression “net taxable capital gains”. The expression is used in subsections 104(21) and (21.2), which permit a trust to flow through its taxable capital gains realized in a year to a beneficiary to whom an amount of the trust's income for the year has been made payable. The trust can flow through its taxable capital gains to beneficiaries only to the extent of its net taxable capital gains for the year.

Under subsection 104(21.3), the amount of a trust's net taxable capital gains for a taxation year equals the amount, if any, by which its total taxable capital gains for the year exceeds the total of two amounts:

- its total allowable capital losses for the year, and
- the amount deducted by it under paragraph 111(1)(b) in computing its taxable income for the year (i.e., deduction of carried-over net capital losses for preceding years and for the three following years).

Subsection 104(21.3) is amended so that allowable business investment losses (ABILs) are disregarded for the purpose of the first of the two amounts. Accordingly, ABILs will not result in a reduction of taxable

capital gains that may be flowed through to beneficiaries under trusts and against which allowable capital losses can be claimed.

This amendment applies to trust taxation years that begin after 2000.

ITA

104(24)

The determination of when an amount becomes payable in a taxation year is relevant for a number of purposes, including the determination of the amount deductible under subsection 104(6) of the Act. Under subsection 104(24), an amount (e.g., income allocated to a beneficiary) is deemed not to have become payable in the year to a beneficiary unless it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount.

Subsection 104(24) is amended so that it also applies for the purposes of paragraph (c) of the definition “specified charity” in subsection 94(1), subsection 94(8) and subsection 104(7.01). For more information, see the commentary on those provisions.

This amendment applies to trust taxation years that begin after 2002. It also applies to trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

## **Clause 22**

### **Cost of Capital Interest**

ITA

107(1.1)

Subsection 107(1.1) of the Act provides rules for computing the cost to a taxpayer of a capital interest in a personal trust or a prescribed trust. Paragraph 107(1.1)(b) provides that the cost is nil, except where certain conditions apply.

Paragraph 107(1.1)(b) is amended so that if a capital interest in a personal trust or prescribed trust is a participating interest in a foreign investment entity, the cost of the capital interest will not be deemed by that paragraph to be nil. For more details, see the commentary on new sections 94.1 to 94.4.

This amendment applies to taxation years that begin after 2002.

ITA  
107(4.01)

New subsection 107(4.01) of the Act provides that subsection 107(2.1) applies (and subsection 107(2) does not apply) to a distribution to a beneficiary by a trust of a property that is a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified participating interest” in subsection 248(1), see the commentary on that definition.

This amendment applies to distributions that occur in taxation years that begin after 2002.

**Clause 23**

**Qualifying Disposition**

ITA  
107.4(1)(k)

Subsection 107.4(1) of the Act defines a qualifying disposition of property to a trust to be a disposition of property to the trust that does not result in any change in the beneficial ownership of the property and that otherwise meets the conditions set out in that subsection. Under subsection 107.4(3), a qualifying disposition generally qualifies for a tax-deferred “rollover” of the property to the trust.

New paragraph 107.4(1)(k) provides that a disposition of property to a trust does not include a disposition of property that is, immediately before the disposition, a specified participating interest.

This amendment applies to dispositions that occur in taxation years that begin after 2002.

**Clause 24**

ITA

108

Section 108 of the Act sets out certain definitions and rules that apply for the purposes of subdivision k, which deals with the taxation of trusts and their beneficiaries.

**Definitions**

ITA

108(1)

**“income interest”**

Subsection 108(1) of the Act contains the definition “income interest”. It is defined as a right of a taxpayer as a beneficiary under a personal trust to, or to receive, all or any part of the income of the trust and after 1999 includes a right (other than a right acquired before 2000 and disposed of before March 2000) to enforce payment by the trust that arises as a consequence of a right that is an income interest.

Under subsection 108(3), “income” for this purpose is determined without reference to the provisions of the Act.

The definition “income interest” is amended to provide that it does not include a participating interest in a foreign investment entity. For more details on foreign investment entities, see the commentary on sections 94.1 to 94.4.

This amendment applies to trust taxation years that begin after 2002.

**“trust”**

Subsection 108(1) of the Act defines “trust”, for the purposes of the 21-year deemed disposition rule and other specified measures, to exclude certain listed trusts.

Paragraph (a.1) of that definition is amended to clarify that its intended application should be limited to health and welfare trusts.

This amendment applies to trust taxation years that begin after 2002. It also applies to trust taxation years that begin after 2000, or after 2001, if



the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

### **Income of a Trust in Certain Provisions**

ITA  
108(3)

Subsection 108(3) of the Act provides that, for the purposes of the definition “income interest” in subsection 108(1), the income of a trust is its income computed without reference to the provisions of the Act.

Subsection 108(3) is amended so that the rule described above also applies for the purposes of the definition “exempt foreign trust” in new subsection 94(1).

This amendment applies to trust taxation years that begin after 2002. It also applies to trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

### **Clause 25**

#### **Deduction in Respect of Dividend Received from Foreign Affiliate**

ITA  
113

Subsection 113(1) of the Act permits a resident corporation to deduct specified amounts in respect of dividends received from a foreign affiliate out of the exempt, taxable and pre-acquisition surplus of the foreign affiliate. The amounts so deductible are determined largely with reference to Part LIX of the *Income Tax Regulations*. The deductions under paragraphs 113(1)(b) and (c) with regard to dividends out of taxable surplus are also determined with reference to the resident corporation's “relevant tax factor”.

Subsection 113(1) is amended to explicitly link the “relevant tax factor” to the resident corporation receiving the dividends and the taxation year in which the dividends are received.

This amendment applies after 2000.

**Clause 26****Part-year Residents**

ITA

114

Section 114 of the Act provides rules for computing the taxable income of an individual who is resident in Canada for a period or periods in a taxation year, and is non-resident for the rest of the year.

Section 114 is amended so that it is subject to paragraph 94.2(5)(c), a rule that applies in connection with a participating interest, in a foreign investment entity, in respect of which the mark-to-market regime under section 94.2 applies to a taxpayer. Paragraph 94.2(5)(c) is, however, only relevant to an individual who ceases to be, and later becomes, resident in Canada in the same taxation year. For further information, see the commentary on new subsection 94.2(5).

This amendment applies to taxation years that begin after 2002.

**Clause 27****Tax Payable by *Inter Vivos* Trust**

ITA

122(2)(d.1)

Subsection 122(1) of the Act provides that, instead of graduated income tax rates, *inter vivos* trusts are generally subject to top marginal rates of income tax on their undistributed income. Subsection 122(2) permits graduated income tax rates for certain *inter vivos* trusts established before June 18, 1971. One of the conditions for an *inter vivos* trust continuing to qualify for graduated income tax rates is that it not receive any gifts after June 18, 1971.

Paragraph 122(2)(d.1) is introduced so that the graduated income tax rates cease to apply to a trust in the event that, after June 22, 2000, a “contribution” is made to the trust. For this purpose, the expression “contribution” is defined in new section 94.

This amendment applies to trust taxation years that begin after 2002. It also applies to trust taxation years that begin after 2000, or after 2001, if

the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

## **Clause 28**

### **Foreign Tax Credit**

ITA

126

Section 126 of the Act provides rules under which taxpayers may deduct, from tax otherwise payable, amounts they have paid in respect of foreign taxes.

ITA

126(1)(a) and (1.2)

Subsection 126(1) of the Act provides a tax credit to a taxpayer in respect of foreign non-business income tax – that is, foreign taxes levied on investment and other non-business income of the taxpayer. However, paragraph 126(1)(a) provides an exception to the effect that no tax credit is available if the taxpayer is a corporation and the foreign taxes paid by the taxpayer are in respect of income from a share of the capital stock of a foreign affiliate of the taxpayer.

Paragraph 126(1)(a) is amended to remove the reference to the exception for taxes paid in respect of income from a share of a foreign affiliate. This exception is now found in subsection 126(1.2).

New subsection 126(1.2) describes circumstances in which subsection 126(1) does not apply. More specifically, it provides that subsection 126(1):

- does not apply to non-business income tax paid by a taxpayer in respect of a particular amount that is included in computing, in respect of the taxpayer, the amount determined under subparagraph 94.4(2)(a)(i) in respect of a participating interest of the taxpayer, if the taxpayer made a deduction under subsection 94.4(3) in respect of the particular amount – in this regard, see the commentary on the related rule found in new subsection 94.3(3), and

- does not apply to non-business income tax paid by a corporation in respect of income from a share of the capital stock of a foreign affiliate of the corporation.

These amendments apply to taxation years that begin after 2002.

## **Clause 29**

### **Changes in Residence**

ITA  
128.1

Section 128.1 sets out the income tax effects of becoming or ceasing to be resident in Canada.

ITA  
128.1(1.1)

Subsection 128.1(1) sets out rules that apply where a taxpayer becomes resident in Canada. Paragraph 128.1(1)(b) treats a taxpayer who becomes resident in Canada as having disposed of the taxpayer's property, with certain exceptions, for proceeds equal to the property's fair market value.

New subsection 128.1(1.1) identifies two sets of circumstances in which paragraph 128.1(1)(b) does not apply to a taxpayer that is a trust.

Under paragraph 128.1(1.1)(a), paragraph 128.1(1)(b) will not apply at a time in a particular taxation year of a trust, to the trust if the trust is deemed, under paragraph 94(3)(a), to be resident in Canada for the particular taxation year for the purpose of computing its income and the trust is resident in Canada (determined, because of paragraph 94(4)(b), without reference to the deeming residency rule in paragraph 94(3)(a)) immediately after the end of the particular taxation year for the purpose of computing its income.

Under paragraph 128.1(1.1)(b), paragraph 128.1(1)(b) will not apply at a time in a particular taxation year of a trust, to the trust if the trust is deemed by paragraph 94(3)(c) to have disposed of property in the particular taxation year.

For more detail on subsections 94(3) and (4), see the commentary on those provisions.



This amendment applies to trust taxation years that begin after 2002. It also applies to trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

## **Clause 30**

### **Exempt Corporations**

ITA

149(10)(c)

Subsection 149(10) of the Act applies where, at a particular time, a corporation becomes or ceases to be exempt from tax under Part I on its taxable income (otherwise than by reason of the exemption for certain insurers in paragraph 149(1)(i)). A new taxation year is considered to start at the particular time and the corporation's properties are deemed to have been disposed of at fair market value and reacquired at the particular time for the same amount.

Paragraph 149(10)(c) provides that the corporation is, for specified purposes in the Act, treated as a new corporation. One of the specified purposes is with regard to the investment tax credit regime set out in subsections 127(5) to (26).

Paragraph 149(10)(c) is amended so that it is also relevant in applying

- additional rules for the investment tax credit that are set out in subsections 127(27) to (35) (this amendment is consequential on the earlier enactment of those subsections), and
- sections 94.1 to 94.4. (For example, a corporation's "deferral amount" (as defined in subsection 94.2(1)) in respect of any interest it holds in a foreign investment entity is determined without reference to taxation years that occurred before the corporation's change of status. This will typically result in a nil deferral amount for the corporation.)

These amendments apply to corporations that, after 2002, become or cease to be exempt from tax on their taxable income under Part I of the Act.

**Clause 31****Assessment and Reassessment**

ITA

152(4)(b)(vi)

In general terms, subsection 152(4) of the Act provides that the Minister of National Revenue may not reassess tax payable by a taxpayer for a taxation year after the normal reassessment period for the taxpayer in respect of the year unless certain conditions described in paragraph 152(4)(a) or (b) have been met. Subparagraph 152(4)(b)(vi) allows the Minister to reassess a taxpayer within 3 years after the end of the normal reassessment period for the taxpayer in respect of the year where the reassessment is made in order to give effect to the application of subsection 118.1(15) or (16) of the Act.

Subparagraph 152(4)(b)(vi) is amended to also allow the Minister to reassess a taxpayer within three years after the end of the normal reassessment period where the reassessment is made in order to give effect to the application of subsection 94(9) or (10). For more information on subsections 94(9) and (10), see the commentary on those subsections.

This amendment applies after 2002.

**Clause 32****Tax Liability – Non-arm's Length Transfers of Property**

ITA

160

Section 160 contains rules regarding the joint and several liability of a taxpayer for the income tax liability of another person who, when not dealing at arm's length with the taxpayer, transferred property to the taxpayer for consideration less than its fair market value.

## **Assessment**

ITA

160(2.1)

New subsection 160(2.1) of the Act allows the Minister of National Revenue to assess a taxpayer at any time in respect of any amount payable because of paragraph 94(3)(*d*) or (*e*). Such an assessment has the same effect as if it had been made under section 152 of the Act and is subject to interest. For more information on paragraphs 94(3)(*d*) and (*e*), see the commentary on those provisions.

This amendment applies to assessments made after 2002.

## **Discharge of liability**

ITA

160(3)

Subsection 160(3) of the Act provides that, where a taxpayer becomes jointly and severally liable with another taxpayer under subsection 160(1) or (1.1) with respect to a tax liability of the other person, a payment by the particular taxpayer on account of the particular taxpayer's tax liability will discharge the joint liability to the extent of the payment.

Subsection 160(3) is amended so that it also applies where the particular taxpayer has become jointly and severally, or solidarily, liable with another taxpayer under because of paragraph 94(3)(*d*) or (*e*) in respect of part or all of a liability under this Act of the other taxpayer. (The expression "solidarily" is added to ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.) For more information on paragraphs 94(3)(*d*) and (*e*), see the commentary on those provisions.

This amendment applies to assessments made after 2002.

## Clauses 33 and 34

### Penalties

#### ITA

##### 162 and 163

Subsections 162 and 163 of the Act impose penalties for infractions such as failing to provide certain information on a return, failing to file a return for a taxation year, and making false statements on a return.

#### ITA

##### 162(10.1) and (10.11)

Subsection 162(10.1) of the Act imposes a penalty on any person or partnership that is more than 24 months late in filing an information return that the person or partnership was required to file under any of sections 233.1 to 233.4. (This penalty applies in addition to the penalties imposed under subsections 162(7) and (10).)

The penalty imposed under subsection 162(10.1) with respect to a particular information return is equal to a specified amount less the amount of the penalties imposed under subsections 162(7) and (10) with respect to the return. The specified amount with respect to an information return for a trust required to be filed by a person or partnership under section 233.2 is equal to 5% of the total fair market value of any property transferred or loaned to the trust that, if no other loan or transfer were taken into account, would have imposed an obligation on the person or partnership to file the return.

Subsection 162(10.1) is amended, as a consequence of amendments made to section 233.2, by changing the manner in which the specified amount is determined. The specified amount is now to be determined with reference to the fair market value of “contributions” made by the person or partnership to the trust.

New subsection 162(10.11) provides that, for the purpose of the calculation in subsection 162(10.1), the definitions and rules in subsections 94(1), (2) and (9) generally apply. Subsection 162(10.11) is similar to amended subsection 233.2(2), described in greater detail in the commentary below.

These amendments apply to returns in respect of taxation years that begin after 2002. They also apply to returns in respect of taxation years



that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

ITA

162(10.3), 162(10.4), 163(2.6) and 163(2.91)

Existing paragraph 94(1)(d) of the Act provides for non-resident trusts to be treated as foreign affiliates. It is being repealed as a consequence of the introduction of new rules for non-resident trusts in section 94. Subsections 162(10.3) and (10.4) are rules that affect the calculation of penalty tax in respect of a person's or partnership's failure to file a return in respect of a foreign affiliate.

Subsections 163(2.6) and (2.91) are similar provisions that affect the calculation of penalty tax in respect of false statements and omissions in such a return.

Subsections 162(10.3) and 163(2.6) are amended to reflect the changes to section 94 under which non-resident trusts are no longer treated as foreign affiliates. Subsections 162(10.4) and 163(2.91) are repealed for the same reason.

These amendments apply to returns in respect of taxation years that begin after 2002. They also apply to returns in respect of taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

ITA

163(2.4)(b) and (2.41)

Subsection 163(2.4) of the Act imposes a penalty on any person or partnership that, knowingly or under circumstances amounting to gross negligence, has made or has participated in, assented to, or acquiesced in, the making of a false statement or omission in a return required to be filed under any of sections 233.1 to 233.6. The penalty under paragraph 163(2.4)(b) relates to a return required to be filed under section 233.2. The existing penalty is the greater of \$24,000 and 5% of the total fair market value of the property that the person or partnership loaned or transferred to the trust that gave rise to the obligation to file.

Paragraph 163(2.4)(b) is amended as a consequence of changes made to the non-resident trust rules in section 94 and the annual reporting requirement in respect of non-resident trusts under section 233.2. Under amended section 233.2, a person is subject to the annual reporting requirement where the person makes a “contribution” to the trust.

Accordingly, amended paragraph 163(2.4)(b) provides for a penalty for a person equal the greater of \$24,000 and a specified amount in respect of the return. The specified amount for a person is essentially equal to 5% of the fair market value of “contributions” made by the person. The specified amount is calculated in the same way as the specified amount under amended subsection 162(10.1) in respect of late-filed returns. Under new subsection 163(2.41), the definitions and rules in subsections 94(1), (2) and (9) generally apply. Subsection 163(2.41) is similar to amended subsection 233.2(2), described in greater detail in the commentary below.

These amendments apply to returns in respect of taxation years that begin after 2002. They also apply to returns in respect of taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

## **Clause 35**

### **Withholding and Remittance of Tax**

ITA  
215

Section 215 sets out rules governing when a person paying or crediting an amount to a non-resident must withhold a portion of the amount paid or credited.

ITA  
215(1)

Subsection 215(1) provides that, where a resident of Canada pays or is deemed to pay an amount to a non-resident person in respect of which the non-resident person is liable for withholding tax under Part XIII, the payer is required to withhold the tax from the amount and remit it to the Receiver General on behalf of the non-resident.

Subsection 215(1) is amended to ensure that, where an amount is paid or credited (or deemed to be paid or credited) to a trust that is deemed, by paragraph 94(3)(a), to be resident in Canada for the purpose of determining the trust's liability for tax under Part XIII, the payer is required to withhold the tax that would otherwise be payable by the trust and to remit it to the Receiver General.

For more detail on the application of Part XIII to trusts deemed, under paragraph 94(3)(a), to be resident in Canada, and to payers of amounts to such trusts, see the commentary on subsection 94(3) and (4) and subsections 216(4.1).

This amendment applies to trust taxation years that begin after 2002. It also applies to trust taxation years that begin

- after 2000 if the trust makes a valid election under the coming-into-force provision of new section 94, and
- after 2001 if the trust makes a valid election under the coming-into-force provision of new section 94.

## **Clause 36**

### **Deduction and Payment of Tax**

ITA  
216

#### **Section 216**

Section 216 of the Act provides certain rules relating to non-residents who elect to be taxed under Part I in respect of certain rental and timber royalty income rather than under Part XIII, which would normally apply in such circumstances.

### **Rents and timber royalties –optional method**

#### **of payment**

ITA  
216(4.1)

In general, Part XIII of the Act imposes a withholding tax of 25% on rental payments made by Canadians to non-resident owners of Canadian

real property. An exception to this general rule exists where a non-resident chooses, under subsection 216(4) of the Act, to file a Canadian income tax return in respect of the rental income and timber royalty income and pay tax on the net amount of such income. Where the conditions of subsection 216(4) are satisfied, the rule requiring a Canadian payer (or agent of the payee pursuant to s. 215(3)) to remit 25% of the gross payment to the CCRA does not apply; instead, only 25% of the net amount of income received by the non-resident's agent need be remitted.

However, an otherwise non-resident trust to which paragraph 94(3)(a) of the Act would apply is deemed resident in Canada for the purposes of determining the liability under Part XIII on amounts paid to the trust. Therefore, the trust would not be able to rely on subsection 216(4), despite the liability, because of paragraph 94(4)(b) and section 215, of a Canadian payer for amounts paid or credited to the trust that would, but for proposed paragraph 94(3)(a), generally have been subject to a tax under Part XIII.

Subsection 216(4.1) is introduced to provide a measure of relief in these circumstances. Under that subsection, if a trust is deemed by subsection 94(3) to be resident in Canada for a taxation year for the purpose of computing the trust's income for the year, a person who is otherwise required by subsection 215(3) to remit in the year, in respect of the trust, an amount to the Receiver General in payment of tax on rent on real property or on a timber royalty may elect in prescribed form filed with the Minister under this subsection not to remit under subsection 215(3) in respect of amounts received after the election is made. Under paragraphs 216(4.1)(a) and (b), if that election is made, the elector shall,

- when any amount is available out of the rent or royalty received for remittance to the trust, deduct 25% of the amount available and remit the amount deducted to the Receiver General on behalf of the trust on account of the trust's tax under Part I; and
- if the trust does not file a return for the year as required by section 150, or does not pay the tax that the trust is liable to pay under Part I for the year within the time required by that Part, on the expiration of the later of the time for filing or payment, as the case may be, pay to the Receiver General, on account of the trust's tax under Part I, the amount by which the full amount that the elector would otherwise have been required to remit in the year in respect



of the rent or royalty exceeds the amounts that the elector has remitted in the year under paragraph 216(4.1)(a) in respect of the rent or royalty.

This amendment applies to trust taxation years that begin after 2002.

## **Clause 37**

### **Foreign Reporting Requirements**

#### **ITA 233.2**

Existing section 233.2 of the Act requires certain persons who have made transfers or loans to a “specified foreign trust”, or to a non-resident corporation that is a controlled foreign affiliate of such a trust, to file annual information returns with respect to the trust. A “specified foreign trust”, as defined in subsection 233.2, includes a trust with a “specified beneficiary” resident in Canada. As defined in subsection 233.2(1), a “specified beneficiary” is generally any beneficiary under the trust with the exception of persons listed in subparagraphs (a)(i) to (x) of the definition. For a return to be required to be filed as a consequence of a transfer or loan, it is necessary to have a “non-arm's length indicator”, as set out in subsection 233.2(2), apply in respect of the transfer or loan. One of the cases where a “non-arm's length indicator” applies in respect of a transfer to a trust is where the transferor is a “specified beneficiary” under the trust. Subsection 233.2(3) provides a look-through rule so that, where a partnership transfers property, it is considered to have been transferred by members of the partnership.

New section 94 sets out new rules governing the taxation of non-resident trusts. In order to be consistent with the new rules:

- the definitions “specified beneficiary” and “specified foreign trust” in section 233.2 are repealed,
- there is no longer a requirement for a “non-arm's length indicator”, so the existing rule in subsection 233.2(2) is repealed,
- except as described below, the definitions and rules of application in subsections 94(1) and (2) apply because of amended subsection 233.2(2), and

- there is no longer a requirement for an explicit look-through rule for partnerships in section 233.2, given that the rule in paragraph 94(2)(o) applies because of amended subsection 233.2(2). Consequently, subsection 233.2(3) is repealed.

Under amended subsection 233.2(4), reporting will generally be required for a taxation year whenever a “contribution” has been made by a person resident in Canada to a non-resident trust at or before the end of the year. Because of amended subsection 233.2(2), the expression “contribution” generally carries the same meaning as in new section 94 with most of the same exceptions for “arm's length transfers” contained in the definition of that expression in subsection 94(1). However, the exception in that definition against transfer of “restricted property” (as defined in subsection 94(1)) is extended to apply to most transfers described in paragraph 94(2)(g) (unless the transfer involves, generally, an issuance of a unit or share from a mutual fund trust, a mutual fund corporation or a corporation other than a closely-held corporation, as the case may be), with the result that such transfers do not give rise to an exception to the obligations for reporting under subsection 233.2(4). It should be noted that amended subsection 233.2(2) also applies for the purpose of new paragraph 233.5(c.1).

New subparagraph 233.2(4)(c)(ii) sets out a list of persons for whom reporting obligations are not imposed. This list is consistent with the list of beneficiaries who are not treated as “specified beneficiaries” under the existing rules in section 233.2.

Amended subsection 233.2(4) of the Act also exempts contributors from filing information returns with regard to trusts described in paragraphs (c) to (i) of the new definition “exempt foreign trust” in subsection 94(1). For more information in this regard, see the commentary on that definition.

These amendments apply to returns in respect of trust taxation years that begin after 2002. They also apply to returns in respect of trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

ITA

233.2(4.1)

New subsection 94(3) of the Act provides that, where a non-resident trust has a resident contributor or resident beneficiary at the end of the trust's taxation year, the trust is generally taxed on its income in Canada for the year as if the trust were resident in Canada. However, the deeming provisions in subsection 94(3) apply only to arrangements that are considered to be trusts for Canadian income tax purposes. In some cases, there may be doubt as to whether a given arrangement is a trust for Canadian income tax purposes.

New subsection 233.2(4.1), in combination with subsection 233.2(4), imposes a filing obligation on contributors to certain entities or arrangements in respect of which reporting is not otherwise required. One of the key objectives of subsection 233.2(4.1) is to ensure that claims that section 94 does not apply can be reviewed by the CCRA.

More specifically, new subsection 233.2(4.1) applies where property has, directly or indirectly, been transferred or loaned by a person to be held

- under an arrangement governed by laws that are not laws of Canada or a province, or
- by a non-resident entity (as defined in subsection 94.1(1)).

The person must, where certain additional conditions are satisfied, file the information return referred to in amended subsection 233.2(4).

New subsection 233.2(4.1) provides that, except as the Minister of National Revenue otherwise permits in writing, the person has obligations under amended subsection 233.2(4) if all of the following conditions are satisfied:

- the transfer or loan is not an arm's length transfer (within the meaning that would be assigned by the definition "arm's length transfer" in subsection 94(1) as amended by subsection 233.2(2));
- the transfer or loan is not solely in exchange for property that would be described in paragraphs (a) to (i) of the definition "specified foreign property" in subsection 233.3(1) if that definition were read without reference to paragraphs (j) to (q) of that definition;

- the entity or arrangement is not a trust in respect of which the person would, without reference to subsection 233.2(4.1) and the explicit exemptions for filing returns contained in subsection 233.2(4), be required to file an information return for a taxation year that includes that time; and
- the entity or arrangement is, for a taxation year or fiscal period that includes that time, not
  - (i) an exempt foreign trust (as defined in subsection 94(1)),
  - (ii) foreign affiliate in respect of which the person is a reporting entity (as defined in subsection 233.4(1)), or
  - (iii) an exempt trust (as defined in subsection 233.2(1)).

Where the above conditions are satisfied, the person's obligations under subsection 233.2(4) and related provisions are determined as if:

- the transfer were a contribution to which paragraph 233.2(4)(a) applied;
- the entity or arrangement were a trust not resident in Canada throughout the calendar year that includes the time of the transfer or loan; and
- the taxation year of the entity or arrangement were that calendar year.

These amendments apply to returns in respect of trust taxation years that begin after 2002. They also apply to returns in respect of trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

## **Clause 38**

### **Returns in Respect of Foreign property**

ITA  
233.3

Section 233.3 of the Act provides reporting requirements in respect of foreign property. In general terms, it provides that certain taxpayers



resident in Canada and certain partnerships must file an information return with respect to their “specified foreign property” if the total cost amount of such property exceeds \$100,000. For this purpose, “specified foreign property” (as defined in subsection 233.3(1)) includes an interest in a non-resident trust or a trust that would be non-resident were it not for section 94. It does not include an interest in a non-resident trust that was not acquired for consideration by the person or partnership.

Paragraph (*d*) of the definition “specified foreign property” is amended by changing a cross-reference to section 94 to a cross-reference to new subparagraph 94(3)(a)(v). This amendment is consequential on amendments to section 94. As a result, interests in trusts deemed to be resident of Canada because of section 94 are “specified foreign property” unless otherwise expressly excluded.

Paragraph (*d.1*) of the definition is introduced so that specified foreign property includes an interest in an insurance policy issued by a non-resident insurer, if the mark-to-market regime in section 94.2 applies in respect of the interest. New paragraph (*d.1*) of the definition applies to returns for taxation years that begin after 2002. For further information in this regard, see the commentary on new subsection 94.2(11).

Paragraph (*l*) of the definition is repealed to eliminate a reference to trusts that are treated as foreign affiliates. This reference is no longer necessary in light of new subsection 94(1), under which non-resident trusts are no longer treated as foreign affiliates.

Paragraph (*m*) of the definition is amended so that the exclusion for non-resident trusts that applies with regard to interests not acquired for consideration also applies to trusts that are deemed by subsection 94(3) to be resident in Canada. This amendment is made for consistency.

Except as indicated above, these amendments generally apply to returns in respect of trust taxation years that begin after 2002. In addition, amended paragraphs (*d*) and (*m*) of the definition “specified foreign property” and the repeal of paragraph (*l*) of that definition apply to returns in respect of trust taxation years that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

**Clause 39****Returns Respecting Foreign Affiliates**

ITA

233.4(1) and (2)

Section 233.4 of the Act provides reporting requirements in respect of foreign affiliates. In general terms, it provides that taxpayers resident in Canada (or certain partnerships) of which a non-resident corporation or non-resident trust is a foreign affiliate must file an information return in respect of the affiliate.

Subsections 233.4(1) and (2) are amended to eliminate references to foreign affiliates that are non-resident trusts. These references are no longer necessary in light of new subsection 94(1), under which non-resident trusts are no longer treated as foreign affiliates.

These amendments apply to taxation years and fiscal periods that begin after 2002. They apply to taxation years and fiscal periods that begin after 2000, or after 2001, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

**Clause 40****Due Diligence Exception**

ITA

233.5

Section 233.5 of the Act provides that, where specified conditions set out in paragraphs 233.5(a) to (d) are met, information required in a return filed under section 233.2 or 233.4 does not include information that is not available to the person or partnership required to file the return. In the case of a return required to be filed by a person or partnership under section 233.2, paragraph 233.5(c) provides that it must be reasonable for the person or partnership to expect, at the time of each transaction entered into by the person or partnership after March 5, 1996 that either gives rise to the requirement to file the return or that affects the information to be reported in the return, that sufficient information would be available to the person or partnership to comply with section 233.2.

Paragraph 233.5(c) is amended so that it applies only in connection with transactions entered into before June 23, 2000 that gave rise to the requirement to file a return for a taxation year of the trust that began before 2003. In connection with trust returns required to be filed for trust taxation years that began before 2003, it must be reasonable for the person or partnership to expect that sufficient information would have been available to the person or partnership to comply with section 233.2 if the proposed amendments to section 94 were not taken into account.

Paragraph 223.5(c) is also amended so that it does not apply to returns required to be filed under section 233.4. It is replaced in this respect by new paragraph 233.5(c.2), without any change in the specified conditions for such returns.

Paragraph 233.5(c.1) is introduced in connection with returns required to be filed under section 233.2 by a person or partnership for a taxation year of the trust that begins after 2002. Where “contributions” (determined with reference to subsection 233.2(2), referred to in the commentary above) are made after June 22, 2000, relief under section 233.5 is available only if it was reasonable for the person or partnership to expect, at the time of each such contribution that either gives rise to the requirement to file the return or that affects the information to be reported in the return, that sufficient information would be available to the person or partnership to comply with section 233.2.

This amendment applies to returns in respect of taxation years that begin after 2002. It also applies to returns in respect of taxation years that begin

- in 2001 or 2002, if the trust makes a valid election under the coming-into-force provision for new section 94 of the Act, in which case section 233.5 of the Act shall be read, in respect of the trust, without reference to paragraph 233.5(c), and
- in 2002, if the trust makes a valid election under the coming-into-force provision of new section 94 Act, in which case section 233.5 of the Act shall be read, in respect of the trust, without reference to paragraph 233.5(c).

## Clause 41

### Definitions

ITA  
248(1)

Section 248 of the Act defines a number of terms that apply for the purposes of the Act, and sets out various rules relating to the interpretation and application of various provisions of the Act.

#### **“controlled foreign affiliate”**

The expression “controlled foreign affiliate” is defined to have the meaning assigned by subsection 95(1).

This definition is amended so that it applies except as expressly otherwise provided in the Act. See, for example, the definition “controlled foreign affiliate” in subsection 17(15).

This amendment applies to taxation years that begin after 2002.

#### **“cost amount”**

This definition is used throughout the Act, particularly in provisions relating to the transfer of properties to and from corporations, trusts and partnerships.

New paragraph (c.2) of the definition provides that, where a cost of property to a taxpayer is determined as of any time under new subsection 94.2(13), that cost is also the “cost amount”, under subsection 248(1), of the property to the taxpayer at that time.

This amendment applies to taxation years that begin after 2002.

#### **“inventory”**

A taxpayer's “inventory” is generally described in subsection 248(1) of the Act as a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year. Rules for “inventory” in section 10 and elsewhere in the Act affect the calculation of a taxpayer's income from business.



The definition “inventory” is amended to exclude property that is subject to the application of subsection 94.1(4) or 94.2(3) of the Act.

This amendment applies to fiscal periods that begin after 2002.

### **“share”**

The definition “share” is amended so that it applies except as the context otherwise requires. For example, if the context requires that the expression “share” refer to a portion of an amount or thing, then it would not carry the meaning otherwise assigned by subsection 248(1).

This amendment applies to taxation years that begin after 2002.

### **“foreign accrual property income”**

The definition “foreign accrual property income” is included in subsection 248(1) so that the definition of this expression in section 95 of the Act applies for the purposes of the Act.

This amendment applies to taxation years that begin after 2002.

### **“foreign investment entity”**

The definition “foreign investment entity” is included in subsection 248(1) so that the definition of this expression in subsection 94.1(1) of the Act applies for the purposes of the Act.

This amendment applies to taxation years that begin after 2002.

### **“non-discretionary trust”**

The definition “non-discretionary trust” is included in subsection 248(1) so that the existing definition of the expression in subsection 17(15) applies for the purposes of the Act. The expression is used in the definition “foreign investment entity” in new subsection 94.1(1).

This amendment applies to taxation years that begin after 2002.

### **“participating interest”**

The definition “participating interest” is included in subsection 248(1) so that the definition of this expression in subsection 94.1(1) of the Act applies for the purposes of the Act.

This amendment applies to taxation years that begin after 2002.

### **“specified participating interest”**

This definition is used throughout the Act, particularly in provisions relating to the transfer of properties to and from corporations, trusts, partnerships, spouses or common-law partners. In general, a transfer of property that is a specified participating interest will not qualify for special rules in the Act that would otherwise allow the transferor of the property to defer recognition, for income tax purposes, of any accrued gains or losses in respect of the property.

A specified participating interest at any time means a property of a taxpayer that at that time is a “participating interest” (e.g., a share of a non-resident corporation, or a beneficial interest in a non-resident trust) of the taxpayer in a “foreign investment entity” (as those expressions are defined in subsection 94.1(1)). However, if the interest is at that time an “exempt interest” (as defined in subsection 94.1(1)) of the taxpayer in the foreign investment entity, it will not be at that time a specified participating interest.

A specified participating interest at any time also means a property of a taxpayer that at that time is a participating interest of the taxpayer in a “tracking entity” (as defined in subsection 94.2(1)). However, if the interest is at that time an exempt interest of the taxpayer in the tracking entity, it will not be at that time a specified participating interest, unless the tracking entity is a controlled foreign affiliate of the taxpayer or is a qualifying entity that is a foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest (within the meaning assigned by paragraph 95(2)(m) of the Act).

For more detail on the definitions “participating interest”, “tracking entity”, “exempt interest”, and “foreign investment entity”, see the commentary on those definitions.

This amendment applies to taxation years that begin after 2002.

### **Civil Law**

#### **ITA 248(3)**

Subsection 248(3) of the Act provides a number of rules that apply for the purposes of applying the Act in relation to the Province of Quebec.

Paragraphs 248(3)(a) to (d) deem certain relationships or arrangements created under the laws of the Province of Quebec to be trusts for those purposes. Paragraph 248(3)(e) clarifies that a person is deemed to be beneficially interested in a trust if the person has any right to receive the income or the capital in respect of property that is deemed, under any of paragraphs 248(3)(a) to (d), to be held in trust. Paragraph 248(3)(f) provides that a person beneficially owns property, even if there is a servitude in respect in the property, in relation to which the person has the rights described in any of subparagraphs 238(3)(f)(i) to (iii).

Subsection 248(3) is amended so that it applies generally for the purposes of the Act.

The rules found in paragraphs 248(3)(a) to (c) of the Act are now found in new paragraph 248(3)(a), which sets out the treatment as a trust of certain relationships or arrangements under civil law.

New paragraph 248(3)(b) ensures that the rules in the Act that apply to trusts (including the rules in new sections 94 to 94.4) also apply to foundations. Where property is at any time property of a foundation (and the foundation is not otherwise treated as a trust or corporation for purposes of the Act), the foundation is deemed under paragraph 248(3)(b) to be at that time a trust, and where the foundation is created by will, to be a trust created by will. Such property is deemed to have been transferred (at the time it first became property of the foundation) to the trust by the person that transferred the property to the foundation, and the property is deemed to be, throughout the period in which it is property of the foundation, held by the trust, and not otherwise.

The provisions of paragraph 248(3)(d) are now found in paragraph 248(3)(c). However, note that new paragraph 248(3)(c) clarifies that it is intended to apply only in respect of arrangements that are neither partnerships nor trusts determined without reference to the paragraph 248(3)(c). In addition, new paragraph 248(3)(c) applies only to an arrangement established on or before Announcement Date. This recognizes that amendments to the Quebec *Civil Code* have rendered the provision's original purpose – to allow for the characterization, in the Province of Quebec, of certain entities as trusts under the Act even though they may not technically constitute trusts under the civil law of Quebec – unnecessary.

The provisions of paragraphs 248(3)(e) and (f) are found in new paragraphs 248(3)(d) and (e), respectively.

These amendments apply to taxation years that begin after Announcement Date.

## Part 2

### Technical Amendments to the *Income Tax Amendments Act, 2000*

#### Clause 42

*S.C. 2001, C.17*  
53(2)(a)

*Income Tax Act*  
73(1)

Subsection 73(1) of the *Income Tax Act* generally provides for a tax-free disposition of capital property if it is transferred by an individual to the individual's spouse, common-law partner or a trust for the exclusive benefit of the spouse or common-law partner during the lifetime of the spouse or common-law partner. For subsection 73(1) to apply, the transferor and transferee must both be resident in Canada at the time of the transfer. Where the transferee is a trust, in respect of transfers that occur in 2000 or 2001, the residency requirement is determined without reference to subsection 94(1) as it read before 2002.

This amendment to the *Income Tax Amendments Act, 2000*, ensures that, in applying subsection 73(1) in respect of transfers that occur in 2000, 2001 or 2002, the residence of a transferee will be determined without reference to section 94 of the Act, as it reads in its application to taxation years that began before 2003.

This amendment is deemed to come into force on June 14, 2001.

#### Clause 43

*S.C. 2001, C.17*  
80(19)

*Income Tax Act*  
107(1)

Paragraph 107(1)(a) of the *Income Tax Act* applies for the purpose of computing a taxpayer's taxable capital gain from the disposition of a capital interest in a personal trust (or a prescribed trust described in section 4800.1 of the *Income Tax Regulations*), except where the interest was an interest in a non-resident *inter vivos* trust purchased by



the taxpayer and the disposition was not by way of a distribution to which subsection 107(2) applies. For this purpose the residency of the trust is to be determined without reference to section 94 as it read before 2002.

This amendment to the *Income Tax Amendments Act*, 2000, ensures that, in applying subsection 107(1) in respect of transfers that occur in 2000, 2001 or 2002, the residence of a transferee trust will be determined without reference to section 94 of the Act, as it reads in its application to taxation years that began before 2003.

This amendment is deemed to come into force on June 14, 2001.





